ATOZ

TAX ADVISERS

LUXEMBOURG

INSIGHTS

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EDITORIAL

Greetings,

Following the long winter hibernation, the end of March was hectic with a series of new tax measures. In March, France and Luxembourg signed a new Double Tax Treaty ("**DTT**"). This DTT largely follows the 2017 OECD Model Tax Convention. The DTT has significant implications for Luxembourg funds investing in real estate in France and for French cross-border workers. In this edition of ATOZ Insights, we summarise the consequences of this new DTT.

On 22 March, the draft law introducing the new BEPS-compliant Intellectual Property ("**IP**") regime was passed by the Luxembourg Parliament. The regime will apply retroactively as from tax year 2018, meaning that Luxembourg taxpayers will be able to immediately benefit from an 80% exemption regime applicable to income related to patents and copyrighted software. In addition, IP assets which qualify for the 80% (corporate) income tax exemption will be 100% exempt from net wealth tax. We have analysed the tax provisions of the new IP law in detail.

A third and final Luxembourg focused article in this issue summarises the consequences of the new, updated AML Law. The Law of 13 February 2018, which entered into force on 18 February 2018, substantially modifies the amended law of 12 November 2004 relating to the fight against money-laundering and against the financing of terrorism.

At a European level, the European Finance Ministers reached, on 13 March 2018, a political agreement on the Proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements. According to this proposed Directive, often known as the proposed Directive on Administrative Cooperation VI or "DAC VI", intermediaries, broadly defined, or taxpayers, will have to report any cross-border transaction which meets certain conditions (i.e. main benefit test and/or hallmarks) to the local tax authorities for further exchange with other tax authorities. We have analysed the possible impacts of DAC VI.

Furthermore, on 21 March, the European Commission issued two directive proposals aiming to ensure that tax laws "fairly" tax digital business activities. The first proposal aims at reforming the EU's corporate tax rules for digital activities. The second one aims at introducing an interim tax on certain revenue from digital activities. We explain the main changes that these proposals would introduce.

On the tax litigation front, at the end of 2017, the Court of Justice of the European Union ("**CJEU**") decided on two cases involving German anti-abuse legislation that denied a (partial) exemption or refund of withholding tax on distributions made by German companies to foreign parent companies. This case law confirmed the Court's previous jurisprudence, and is expected to have a significant impact on anti-abuse provisions in place in several European countries. Our article provides an overview of the limitations set by the CJEU on the scope of anti-abuse legislation in an EU context.

From a regulatory point of view, on 12 March 2018, the European Commission issued a series of legislative proposals to amend the existing legal framework for the cross-border distribution of investment funds in the EU. These Proposals aim at modifying the AIFM and UCITS Directives as well as introducing a regulation to standardise the requirements for cross-border distribution of both AIFs and UCITS in the EU. In our article, we give details on what we think the Commission got right and where we feel improvements can still be made.

Lastly, in our final article, we analyse what Brexit means from an indirect tax perspective. The UK should, in principle, not be subject to European legislations as from 30 March 2019, the date from which the UK will become a "third country" for the European entities. This major change will have significant indirect tax consequences.

We hope you enjoy these insights.

The ATOZ Editorial Team

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NEW FRANCE-LUXEMBOURG DOUBLE TAX TREATY

OUR INSIGHTS AT A GLANCE

- On 20 March 2018, France and Luxembourg signed a new Double Tax Treaty ("DTT"), following the structure and, for the most part, the content of the 2017 OECD Model Tax Convention.
- In order to address some forms of treaty abuse, the new DTT contains a principal purposes test in accordance with Actions 6 and 15 of the Base Erosion and Profit Shifting Action Plan meaning that a DTT benefit will be denied if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction.
- Most notably is the treatment of dividend distributions to ensure that dividend distributions by French OPPCI and SIIC are subject to a WHT of either 15% or 30%, depending on the shareholding held by the Luxembourg resident company. This change will incontestably impact real estate investments made by Luxembourg companies in France.
- The new DTT will apply to taxes in relation to the calendar year, which will follow the entry into force of the DTT, i.e. to taxes in relation to the tax year 2019 at the earliest.

On 20 March 2018, France and Luxembourg signed a new Double Tax Treaty ("DTT"). The aim of the new DTT is to replace the existing treaty that was signed in 1958, and amended 4 times in subsequent years. The DTT follows the structure and, for the most part, the content of the 2017 OECD Model Tax Convention. We present the main provisions of the DTT, which will, in particular, give rise to important changes regarding the taxation of real estate investments made by Luxembourg companies through dedicated French investment vehicles.

New Preamble and Principle Purposes Test

In line with the latest version of the OECD Model Tax Convention and the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or "MLI"), the following preamble has been included in the DTT: the aim of the DTT is the elimination of double taxation with respect to taxes on income and on capital while guarding against situations of non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements).

In addition, in order to address some forms of treaty abuse, the DTT contains a principal purposes test ("PPT") in accordance with Actions 6 and 15 of the Base Erosion and Profit Shifting ("BEPS") Action Plan, and in line with the guiding principle of paragraph 9.5 of the Commentary included in 2017 OECD Model Tax Convention. Under this PPT, a DTT benefit will be denied if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction (subjective test). However, DTT benefits will still be granted if it can be demonstrated that granting such benefits, in the circumstances at hand, would remain in accordance with the object and purpose of the relevant provisions of the DTT (objective test). Given the complexity in interpreting and applying this provision which will have to be read in conjunction with EU law (as defined at several occasions by the Court of Justice of the EU), it is recommended to seek advice from a tax adviser when setting up cross-border investments.

Persons Covered and Tax Residence

As far as persons covered are concerned, tax transparent entities (partnerships) are excluded from the qualification of person for the DTT purposes. Nevertheless, the DTT could be

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applied to either France or Luxembourg source income derived through a transparent entity located in Luxembourg or in a third State having concluded with the source State a convention on administrative assistance, subject to the condition that the tax transparent treatment of the partnership is also recognised by the third State. French partnerships subject to tax in France are excluded from this provision and are treated as tax residents of France for the purpose of the DTT.

As far as tax residence is concerned, the DTT amends the existing rules applicable in cases of conflict of company residence and provides that a company is considered as resident in the State in which its effective place of management is located.

Application of some DTT provisions to Collective Investment Vehicles ("CIVs")

Contrary to the current version of the tax treaty, the DTT expressly states (in its Protocol) that it will apply to CIVs under certain conditions. This approach is notably compliant with the OECD report "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles". The Protocol to the DTT provides that a CIV established in a Contracting State, to the extent it is assimilated to a CIV under the legislation of the other Contracting State, may be granted some of the DTT benefits under certain conditions. The CIV (e.g. a Luxembourg SICAV or SICAF) will be able to claim the benefits under articles 10 (dividends) and 11 (interest) in order to benefit from the reduced withholding tax ("WHT") rates on dividends and the exemption of WHT on interest, but only up to the portion of the units/shares held in the CIV by "good" or "qualifying" investors. "Good investors" are defined as investors resident in a country which has concluded a convention on administrative assistance in order to fight against tax fraud and tax evasion with the country in which the CIV invests. The DTT gives no indication as to the practical application of these conditions (how to calculate the portion of good investors? at what moment? etc.). Therefore, this provision seems very difficult to apply practically for CIVs, especially for those held widely and/or for open-ended CIVs.

Permanent Establishment

The definition of permanent establishment set forth in the DTT is now fully based on the BEPS definition. In this respect, the definition generally corresponds to the position taken by France and not to the one that Luxembourg defended, notably in relation to the MLI.

As a result, (1) the qualification of "dependent agent" is extended, (2) the scope of the preparatory and auxiliary activities exemption is based on a lighter BEPS option, (3) the anti-fragmentation rule which limits the preparatory and auxiliary exemption scope is introduced and, (4) anti-abusive splitting-up of contracts for construction site period computation purposes is also added.

Dividends

Under the DTT, dividends will be subject to a WHT of maximum:

- 0% if the beneficial owner is a company which directly holds at least 5% (previously 25% under the current DTT, but 10% under the EU Parent Subsidiary Directive) of the capital of the paying entity for a period of 365 days, including the day of the dividend payment;
- Domestic rate (currently 30% in France) if the dividend is paid out of tax exempt income or gains derived from immovable assets by an investment vehicle, established in a Contracting State, which distributes annually most of its income, if the beneficial owner of the dividend is resident in the other Contracting State and holds, directly or indirectly, a shareholding of 10% or more in the share capital of the investment vehicle;
- 15% in all other cases (including in cases where the beneficial owner of the dividend paid by the real estate investment vehicle described above, holds a participation of less than 10% in this vehicle).

The aim of this provision is to make sure that dividend distributions by French OPPCI and SIIC are subject to a WHT of either 15% or 30%, depending on the shareholding held by the Luxembourg resident company. This change will incontestably impact real estate investments made by Luxembourg companies in France.

Interest and royalties

Interest will only be taxable in the country of the recipient, and thus cannot be subject to WHT in the source country. This was already the case under the previous DTT and is currently not particularly relevant given that both countries do not levy WHT on interest under their internal law.

Royalties which are taxable in the country of the recipient could also be subject to a WHT of maximum 5% in the source country, which is corresponds to the rate applicable under the previous DTT.

Capital gains & real estate rich companies

In principle, gains derived from the alienation of movable assets are taxable in the Contracting State of residence of the alienator.

The new DTT slightly amends the specific provision applicable since 2017 (based on the 2014 Protocol) to capital gains realised on the sale of real estate rich companies. The change introduced in the DTT relates to when the 50% threshold of real estate assets needs to be assessed. According to the amended provision, capital gains derived by a resident of a Contracting State from the alienation of shares and similar rights in a company, deriving directly or indirectly more than 50% of its

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value from immovable property situated in the other Contracting State at any time during the 365 days preceding the alienation, may be taxed in that other State. As under the current provision, the rule applies to shares or other rights held both in a company resident in one of the Contracting States and in a company resident in a third country.

The DTT also introduces a rule according to which gains derived by an individual resident in one of the Contracting States from the alienation of a substantial shareholding (i.e. a direct or indirect shareholding giving rights to at least 25% of the profits of the company) in the share capital of a company resident in the other Contracting State are taxable in this Contracting State and not in the residence State of the alienator if the individual was resident of the other Contracting State at any time during the 5 years preceding the alienation of the shareholding. It appears to us that the compliance of this rule with some European fundamental rights could be challenged.

Employment income

As far as employment income is concerned, even though the rule has been redrafted to follow the OECD Model Tax Convention wording, the rule remains that the income derived by a resident of a Contracting State from employment shall be taxable only in that State, unless the employment is "effectively" exercised in the other Contracting State. In other words, a French tax resident employed by a Luxembourg employer is taxed in Luxembourg on his or her employment income, but only to the extent that the work is effectively performed in Luxembourg.

Here, it is worth mentioning that the situation of cross-border workers will change slightly due to the fact that the Residence State of the employee will not be able to challenge the taxation of the salary in the State of the employer as long as the number of days spent by the employee outside of the employment State does not exceed 29 days per year. While this may appear to be good news at first sight for French cross-border workers, it seems that in certain cases, the practice of the French tax authorities has been even more flexible: in 2012, while responding to a parliamentary question, the French Minister of Economy mentioned that a French employee of a Luxembourg company would remain taxable in Luxembourg on his or her salary to the extent that the employee did not spend more than one day per week (i.e. approximately 50 days per year) working in France.

Pensions

As far as pensions are concerned, pensions paid out of a compulsory social security system will generally be taxed in the source country.

Methods to avoid double taxation

France generally applies the credit method, with certain limits, to avoid double taxation. The benefit of a tax credit corresponding to the French tax for a French resident is subject to an effective taxation in Luxembourg.

Luxembourg generally applies the exemption method. However, the credit method applies to dividends, royalties and income of artists and sportsmen.

Entry into force

The new DTT will enter into force as soon as France and Luxembourg have exchanged the instruments of ratification, following the ratification in their respective country. The new DTT will apply to taxes in relation to the calendar year, which will follow the entry into force of the DTT, i.e. to taxes in relation to the tax year 2019 at the earliest.

Implications

The DTT introduces significant changes, especially for real estate investments in France. Luxembourg taxpayers with investments in France or that plan to invest in France should seek advice from their tax adviser in order to analyse the potential impact of the new provisions on their investments.

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BEPS-COMPLIANT IP REGIME ENTERS INTO FORCE

OUR INSIGHTS AT A GLANCE

- On 19 April 2018, the law introducing the new Luxembourg BEPS-compliant Intellectual Property (IP) regime was published. With retroactive effect as from tax year 2018, Luxembourg taxpayers now benefit from an 80% exemption regime applicable to income related to patents and copyrighted software.
- The only IP assets that can qualify for tax benefits under an IP regime are patents and other IP assets that are considered as functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, where such processes are relevant.
- Marketing assets such as trademarks and domain names are expressly excluded from the scope of qualifying assets.
- As was the case for the previous IP regime, the new regime applies to all Luxembourg taxpayers. This means that the regime is available to both individuals and corporate taxpayers.

On 19 April 2018, the law introducing the new Luxembourg BEPS-compliant Intellectual Property (IP) regime was published. With retroactive effect as from tax year 2018, Luxembourg taxpayers now benefit from an 80% exemption regime applicable to income related to patents and copyrighted software. In addition, IP assets which qualify for the 80% (corporate) income tax exemption are 100% exempt from net wealth tax.

Which taxpayers can benefit from the new regime?

As was the case for the previous IP regime, the new regime applies to all Luxembourg taxpayers. This means that the regime is available to both individuals and corporate taxpayers.

Which IP assets are covered by the new regime?

Luxembourg has defined the scope of the new IP regime in accordance with the conclusions reached in the OECD BEPS Action 5 report. Accordingly, the only IP assets that can qualify for tax benefits under an IP regime are patents and other IP assets that are considered as functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, where such processes are relevant.

Therefore, IP rights covered by the new Luxembourg regime are patents defined broadly and copyrighted software. These IP rights fall within the scope of the new regime to the extent that they are not marketing-related IP assets and were created, developed or enhanced after 31 December 2007 (the former IP regime provided the same limitation in time) as a result of research and development (R&D) activities:

- Patents defined broadly: inventions protected pursuant to domestic and international provisions in force, by a patent, a utility model, a supplementary protection certificate, a patent extension for pediatric medicines, a plant variety protection title, orphan drug designations; and
- Copyrighted software: software protected by copyright according to the national and international provisions in force.

Marketing assets such as trademarks and domain names are expressly excluded from the scope of qualifying assets.

How is the income receiving tax benefits determined?

The modified nexus approach defined in the BEPS Action 5 report aims to ensure that IP regimes only provide benefits to taxpayers that engage in R&D. The reason is that IP tax regimes aim at encouraging R&D activities. As a consequence, according to the nexus approach, a taxpayer is able to benefit from the IP regime to the extent that it can be demonstrated

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that the taxpayer incurred expenditures, such as R&D which gave rise to the IP income.

The nexus approach which determines what income may receive tax benefits is as follows:

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Adjusted net qualifying income from IP asset} = \text{Income receiving tax benefits}$$

Accordingly, when a taxpayer has only one single IP asset and incurs all of the expenditures to develop that asset itself, the nexus approach allows all of the income from that IP asset to qualify for tax benefits.

In order to compute the amount of income which comes within the ambit of the new Luxembourg IP regime, it is necessary to determine:

- which expenditures are considered as “qualifying expenditures incurred to develop IP assets”,
- which expenditures are considered as “overall expenditures incurred to develop IP assets” and
- how the net qualifying income from IP asset is computed.

Both the qualifying expenditures incurred to develop IP assets and the overall expenditures incurred to develop IP assets have to be taken into account at the time when they are incurred, no matter the treatment for accounting or tax purposes.

The law defines these expenditures as follows:

Qualifying expenditures incurred to develop IP assets are expenditures which are necessary for undertaking R&D activities, directly linked to the creation, the development or the enhancement of a qualifying IP asset and incurred by the taxpayer for undertaking his own R&D activities.

Expenditures which are not directly linked to the qualifying IP assets are not taken into account. It follows that the following expenditures are not considered as qualifying expenditures:

- Interest and other costs for financing the IP assets;
- Real estate costs;
- Acquisition costs; and
- Costs not directly related to a qualifying IP asset.

Expenditures for unrelated-party outsourcing performed through a related party are considered as qualifying expenditures, as long as no margin is realised by the related party on its activity linked to the qualifying IP asset. Qualifying expenditures also include expenditures incurred by a foreign permanent establishment (PE) but allocated to the Luxembourg taxpayer in accordance with a double tax treaty, provided that the foreign PE:

- is located in a State which is party to the Agreement on the European Economic Area;
- is operational when the qualifying IP income is realised; and
- does not benefit from a similar IP regime in the country where it is situated.

Finally, when computing the amount of qualifying expenditures, taxpayers are allowed to apply a 30% “up-lift” (up to the amount of the taxpayer’s overall expenditures) to “compensate” for the exclusion of costs incurred by related parties or for the acquisition of IP rights. Hence, the up-lift may increase the amount of IP income that benefits from the new IP regime. The purpose of the up-lift is to ensure that the modified nexus approach does not unfairly penalise taxpayers for acquiring IP or outsourcing R&D activities to related parties.

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In light of the above, if the taxpayer conducts all R&D activities itself and develops IP on its own, the beneficial percentage is 100% and all of the income arising from the IP benefits from the IP regime. If, however, the IP has been entirely acquired from a third entity, through purchase or licensing, the acquisition expenditures (for example, purchase fees or royalties) cannot be included in qualifying expenditures but should be included in overall expenditures. Hence, none of the IP income can qualify for the relevant tax benefit.

Overall expenditures incurred to develop IP assets correspond to the sum of the qualifying expenditures as defined above (but without the 30% lift-up), the costs for the acquisition of the qualifying IP assets as well as the costs for related-party outsourcing.

Adjusted net qualifying income from IP assets corresponds to the net positive difference between:

- The income realised on the qualifying IP assets (the "qualifying income"), i.e. positive income received for the right to use the qualifying IP right; income directly linked to the qualifying IP asset and incorporated into the sale price of a product or service; income realised on the disposal of such IP rights and the indemnity received in relation to the qualifying IP asset following a judicial proceeding or an arbitration procedure; and
- The overall expenditures and the expenditures incurred during the financial year which are indirectly related to a qualifying IP asset. The law also provides for adjustment and offset of the net qualifying income. The purpose of such adjustment is to ensure that the net qualifying income incurred by a qualifying IP asset during a financial year only benefits from a partial IP exemption provided that the overall net qualifying income exceeds the operating expenses (i.e. direct and indirect expenses in connection with the asset). The offset is applicable when the taxpayer holds more than one qualifying IP asset. In that case, the positive adjusted net qualifying income generated by the qualifying IP asset shall be offset against the negative adjusted income of any other qualifying IP asset. The positive net qualifying income after such adjustment and offset shall benefit from the partial exemption.

How is income receiving tax benefits treated under the new regime?

Under the new regime, for individuals, the income receiving tax benefits, as computed above, benefits from an 80% exemption; the effective taxation of the IP income depends on the amount of income realised by the individual, due to the fact that the Luxembourg income tax rate is progressive and ranges between 0 and 42% (plus a solidarity surcharge).

As far as companies are concerned, the income receiving tax benefits is 80% exempt from corporate income tax (CIT). Since the taxable basis for municipal business tax (MBT) purposes is the same as the CIT basis, the 80% exemption applies for both CIT and MBT purposes. Taking into account the CIT rate currently applicable and the additional MBT charge, the effective corporate tax rate applicable to the income receiving tax benefits is:

$$26.01 * 20\% = 5.20\%.$$

How are qualifying IP assets treated for net wealth tax (NWT) purposes under the new regime?

IP rights qualifying for the new IP regime benefit from a 100% NWT exemption.

Implications

The law applies retroactively as from tax year 2018.

The introduction of a new IP regime is positive for both Luxembourg taxpayers and for Luxembourg itself as the regime should attract new R&D activity to Luxembourg and strengthen existing IP management and development activities. While the IP regimes implemented by countries participating in the BEPS project will become more and more similar given that these regimes have to comply with the modified nexus approach, it was important that Luxembourg make the most advantageous choices, exhausting all options provided in the Final Report on Action 5. The Luxembourg legislator decided, in particular, to adopt the optional 30% up-lift on qualifying expenses. Moreover, even IP income that is embedded in the sales price of products or services may benefit from the IP regime.

Lastly, we would like to emphasise that taxpayers which benefited from the former IP regime before it was repealed (as of 30 June 2016) and which hold IP assets that no longer qualify under the new regime (e.g. trademarks) can still benefit from the former partial exemption regime on income and capital gains realised during a grand-fathering period which will end on 30 June 2021.

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AMENDMENT TO THE LUXEMBOURG AML-TF FRAMEWORK

OUR INSIGHTS AT A GLANCE

- The Law of 13 February 2018, entered into force on 18 February 2018, substantially modifies the amended law of 12 November 2004 relating to the fight against money-laundering and against the financing of terrorism ("**AML Law of 2004**").
- This law introduces new categories of professionals (individuals or entities) that will need to comply with the AML Law of 2004 including persons exercising the activity of Family Office, bailiffs, asset dealers, betting and gambling establishments, some trust and company service providers and other financial institutions exercising their activities in Luxembourg.
- Among the changes: the risk-based approach has been reinforced, additional customer due diligence must be performed in some cases, the beneficial owner of customers must be identified (and listed in the Luxembourg Trade and Companies Register), the definition of "politically exposed person" has been introduced and additional internal organisation requirements have been set.
- Violations of customer due diligence obligations, of the obligation to have an appropriate internal organisation, or of the obligation to cooperate with the authorities, will constitute administrative or criminal offences with fines up to 5,000,000€.

The Law of 13 February 2018

The Law of 13 February 2018, entered into force on 18 February 2018, substantially modifies the amended law of 12 November 2004 relating to the fight against money-laundering and against the financing of terrorism (the "**AML Law of 2004**").

Categories of professionals subject to the AML law of 2004

There are new categories of professionals (individuals or entities) that will need to comply with the AML Law of 2004:

- all persons exercising the activity of Family Office;
- bailiffs, when they proceed over auctions of movable assets and harvests;
- asset dealers, for all payments made or received in cash exceeding EUR 10,000;
- all betting and gambling establishments;
- trust and company service providers, when they (i) act as director of a partnership, or (ii) provide business premises;
- other financial institutions exercising their activities in Luxembourg, including Luxembourg branches of financial institutions headquartered within or outside the European Union.

As a reminder, the professionals listed above, together with credit institutions, financial institutions, insurers, brokers, pension funds, notaries, lawyers, accountants, real estate agents, investment funds and their management companies and managers, and investment professionals, are already subject to the revised AML Law of 2004 (the "**Professionals**" or "**obliged entities**") in their relationship with their clients and / or investors (the "**Customers**").

Reinforced risk-based approach

All Professionals must assess the risks of money laundering and terrorism financing ("**ML-TF**") to which they are exposed in their business. They need to take into account multiple categories of risk variables linked to the type of clients (politically exposed persons or highly regulated entities), the location of their clients or activities (Financial Action Task Force ("FATF") countries or

states with endemic corruption), or the services and products they provide (prone to anonymity, involving intermediaries, or highly complex).

This risk assessment exercise is a continuous one. Moreover, Professionals should assess and document ex-ante ML-TF risk-assessments before launching any new products or implementing new business practices (including opening up new distribution channels or using new technologies).

The risk of ML-TF should be assessed on a business-wide level and on a Customer relationship level.

Professionals can neither rely on a predefined list of transactions, nor solely on the central registers of beneficial owners that will be put in place across the European Union to fulfil their risk assessment obligations.

Customer due diligence and Beneficial owners

Professionals must adapt the customer due diligence ("**CDD**") level (simplified, reinforced) and measures (scrutinise unusual transactions, verify ownership beyond the 25% ownership) that they put in place to the level of ML-TF risk identified.

All Professionals must identify the individual(s) who are the beneficial owner(s) of their Customers. For example, the beneficial owner could be:

- individuals controlling corporations (either through ownership - the 25% plus one share threshold - or other means, such as voting rights or rights to appoint the management bodies) or managing them;
- different categories of beneficial owners of trusts, foundations or legal constructions similar to trusts (not only beneficiaries, but also the settlor, trustee or protector); or
- beneficiaries of life-insurance or insurance-based contracts.

Politically exposed persons ("PEP")

The distinction between foreign and national PEP has been removed from the amended Law of 2004.

The PEP definition now includes three categories of persons, namely:

- an individual who is or who has been entrusted with prominent public functions;
- his/her family members (including brothers and sisters); and
- persons known to be close associates.

Professionals should update their CDD files considering that the PEP category will include members of legislative bodies similar to parliaments, of governing bodies of political parties, of management boards of central banks, as well the as board members of international organisations.

Professionals' internal and group-wide organisation

Professionals should adapt their organisation to the ML-TF risks linked to their business and:

- put in place appropriate internal policies, controls and procedures to identify and manage the ML-TF risks they face, to cooperate with authorities, to ensure the protection of personal data collected;
- document the risk assessment exercise;
- review Customers' files in order to correctly identify all beneficial owners, considering the definitions and categories newly introduced;
- keep records of the relevant beneficiary ownership information and register it in the Trust Register/ REBECO (when applicable);
- appoint a person in charge of supervising the AML-TF practices (employee or independent internal auditor);
- train staff and raise awareness with respect to AML-TF obligations and criminal practices;
- implement a specific, independent and anonymous way to enable its staff to report violations of the obligations relating to the AML-TF fight;
- put into practice, in both EU and non-EU subsidiaries and branches, group-wide policies and procedures, in particular with respect to data protection and information sharing within the group for the purpose of combatting ML-TF and ensure adherence to the strictest standards;
- review the beneficial ownership checks performed by group entities or third parties in order to ensure they can be relied upon;
- inform Customers about personal data processing and rights within the ML-TF framework.

Sanctions

Violations of CDD obligations, of the obligation to have an appropriate internal organisation, or of the obligation to cooperate with the authorities, will constitute administrative or criminal offences. The control authorities can apply administrative penalties and suspend or withdraw the authorisation of the Professional, apply a temporary ban on the exercise of the profession or impose administrative fines. In addition, criminal fines of up to EUR 5,000,000 can be imposed.

Additional bills of law relating to the register of beneficial owners of legal persons and the trust register

A register of beneficial owners ("**REBECO**") of legal persons registered in Luxembourg (except for the entities listed on a recognised stock exchange) ("**Concerned entities**") will be managed by the Luxembourg Trade and Companies Register ("**RCSL**" – to be renamed the Luxembourg Business Registers "LBR").

The information to be registered for each beneficial owner is the following: (i) the identity (name, first name, nationality, date and place of birth, country of residence, precise personal or

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professional address, and official identification number), (ii) the nature and extent of beneficial interests held, as well as (iii) any changes thereto.

Concerned entities must keep an up-to-date beneficial ownership file at their registered office, containing the same information as that which has been filed with the REBECO. After the Concerned Entity's liquidation or migration, the file must be maintained at the Luxembourg address indicated in the liquidation (or migration) deed for a period of five years.

The information in the REBECO will only be available to varying degrees to: national authorities, judicial authorities, Professionals within the framework of their CDD obligations, self-regulatory bodies (Bar, Chamber of Notaries, IRE, OEC, Chamber of Bailiffs) exercising their supervisory function in the context of the fight against ML-TF, any Luxembourg resident person/organisation that can prove a legitimate interest.

A register of beneficial owners of any trust that generates tax consequences (Luxembourg fiducies, foreign law trusts, foundations or legal arrangements with legal effects similar to trusts) ("**Trusts**") will be managed by the Administration of Registration and Domains ("**AED**") (**Trust Register**"). The Luxembourg trustees (credit institutions, investment firms, variable or fixed capital investment companies, securitisation undertakings, fund management companies of investment funds or securitisation funds, pension funds, insurance or reinsurance undertakings, national or international public bodies operating in the financial sector) need to gather and register the ultimate beneficial ownership information in the Trust Register.

The beneficial owners to be registered are the settlor, trustee, beneficiary(ies), protector and any other individual that exercises an effective control on the Trust. The identity or identification details and any changes thereto, of each beneficial owner must be registered in the Trust Register.

The information in the Trust Register will be available to national and judicial authorities only. In addition, the information must be made available by Trustees when they enter into a business relationship with Professionals, and when the latter perform their CDD obligations.

Grand Ducal Regulations will provide further details on the access to and consultation of the REBECO and Trust Register, as well as the registration of information and supporting documents to be filed.

Concerned Entities and Trustees will have six months to register the beneficial ownership information in the REBECO and Trust Register, following the entry into force of the relevant law(s).

Administrative penalties and criminal fines of up to EUR 1,250,000 may apply for violations of the obligation to gather and register beneficial ownership information in the REBECO and the Trust Register.

How ATOZ can help you fulfil your obligations:

- We advise on compliance requirements and train your staff involved in AML-TF matters.
- We prepare and compile the information and supporting documents to be filed.
- We check the quality and consistency of the information and supporting documents provided by the client prior to filing.
- We prepare and handle the filing with the REBECO and the Trust Register (once applicable).
- We review, analyse and provide solutions in cases of refusal from the REBECO and Trust Register.
- We ensure the quality and consistency of beneficial owner files to be kept by entities at their registered office.
- We safekeep beneficial owner files on behalf of liquidated or migrated entities during the mandatory five year period following liquidation or migration.
- We assist in replying to requests from register/national authorities/self-regulation bodies/professionals in the context of beneficial owner information.

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POLITICAL AGREEMENT REACHED ON EU PROPOSAL SETTING NEW TRANSPARENCY RULES FOR INTERMEDIARIES

OUR INSIGHTS AT A GLANCE

- On 13 March 2018, the EU Finance Ministers reached a political agreement on the Proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements.
- The Directive Proposal aims at the disclosure, by EU intermediaries (such as lawyers, advisers, accountants), of potentially aggressive tax planning arrangements that have a cross-border dimension.
- A series of specific and general Hallmarks have been identified and defined in the proposal in order to aid the determination of reportable cross-border arrangements. However, the Directive proposal does not provide any precise definition of the concept of "potentially aggressive tax planning" and supplies a very broad definition of "cross-border arrangement".
- Taxpayers that intend to invest abroad (within or outside the EU) or that are in the process of investing abroad should seek advice from their tax adviser in order to analyse the potential impact of the new reporting requirements on their investments.

On 13 March 2018, the EU Finance Ministers reached a political agreement on the Proposal for a Council Directive amending Directive 2011/16/EU ("**DAC**") as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (the "**Directive Proposal**").

This article provides an overview of:

- what type of arrangement will need to be reported;
- what the Hallmarks used to determine the reportable cross-border arrangements under the Directive Proposal are;
- which information will be reported;
- who will be subject to the new reporting duties;
- when the reporting will have to be performed; and
- what the next steps and the implication of the Directive Proposal are.

What will need to be reported under the Directive Proposal?

The Directive Proposal aims at the disclosure, by EU intermediaries, of potentially aggressive tax planning arrangements that have a cross-border dimension.

Therefore, in order to be subject to mandatory reporting, the arrangement has to:

- be cross-border; and
- be a potentially aggressive tax planning arrangement.

Cross-border arrangement

An arrangement is considered as cross-border if it concerns either (i) more than one EU Member State or, (ii) an EU Member State and a third country. In addition, to be considered as cross-border arrangement:

- its participants must be resident for tax purposes in at least two different jurisdictions; or
- at least one of its participants is simultaneously resident

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for tax purposes in more than one jurisdiction; or
- at least one of its participants carries on a business in another jurisdiction through a permanent establishment ("**PE**") located in this jurisdiction and the arrangement is part or the whole of that PE's business; or
- at least one of its participants carries on an activity in another jurisdiction without being resident for tax purposes or creating a PE in that jurisdiction; or
- the arrangement has a possible impact on the automatic exchange of information or the identification of beneficial ownership.

This definition is so broad that any company having a subsidiary or a permanent establishment in another country may be covered and thus, any transaction with a subsidiary would then become potentially a "cross-border arrangement".

Potentially aggressive tax planning arrangement

The Directive Proposal does not provide any precise definition of the concept of "aggressive tax planning". Instead, the thinking is that it would be more effective to capture potentially aggressive tax arrangements through compiling a list of features and elements of transactions that present a strong indication of tax avoidance or abuse. As a result, a cross-border arrangement which satisfies at least one of the Hallmarks will be reportable. In other words, a cross-border arrangement that contains at least one of the characteristics or features that is deemed to present an indication of a potential risk of tax avoidance, as listed in Annex IV of the Directive Proposal (the "**Hallmarks**"), are considered as reportable. But there is the rub! These Hallmarks are not necessarily a strong indicator of tax avoidance or abuse but are much broader: as drafted, they do not only capture aggressive tax planning or tax avoidance.

In order to be taken into account, certain Hallmarks must fulfil a main benefit test ("**MBT**"). This test will be satisfied if "it can be established that the main benefit or one of the main benefits which, having regard to all relevant facts and circumstances, a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage". This MBT has the merit of not being subject to circular reasoning, as was the case in the June 2017 proposal. However, this MBT remains quite vague as it refers broadly to "a person" and not to the relevant taxpayers involved, directly or indirectly, in the arrangement. This further raises a question as to how "person" should be interpreted. Should it be a person with a similar profile to the taxpayer or any persons? Moreover, The MBT only refers to benefits that someone "may reasonably expect" and not to a benefit that is actually sought by the relevant taxpayers. This is therefore a very subjective test, creating legal uncertainty. The simple fact that there is a person (and not necessarily a participant) who could gain a tax advantage by implementing the arrangement seems to be sufficient to conclude that the MBT has been met.

The Directive Proposal shall apply to all taxes, of any kind, levied by, or on behalf of, a Member State or the Member State's territorial or administrative subdivisions, including the local authorities. However, the Directive Proposal shall not apply to value added tax and customs duties, nor to excise duties covered by other Union legislation on administrative cooperation between Member States. This Directive shall also not apply to compulsory social security contributions.

What are the Hallmarks used to determine the reportable cross-border arrangements under the Directive Proposal?

The Hallmarks are classified into 5 categories:

- General Hallmarks linked to the MBT;
- Specific Hallmarks linked to the MBT;
- Specific Hallmarks related to cross-border transactions;
- Specific Hallmarks concerning automatic exchange of information and beneficial ownership; and
- Specific Hallmarks concerning transfer pricing.

a. *General Hallmarks linked to the MBT*

Pursuant to Annex IV of the Directive Proposal, the general criteria based on which cross-border arrangements will be reportable, if they meet the MBT, are the following:

- Where the relevant taxpayer or a participant in the arrangement undertakes to comply with a condition of confidentiality which may require them not to disclose how the arrangement could secure a tax advantage vis-à-vis other intermediaries or the tax authorities.
- Where the intermediary is entitled to receive a fee (or interest, remuneration for finance costs and other charges) for the arrangement and this fee is determined according to (a) the amount of the tax advantage derived from the arrangement or (b) whether or not a tax advantage is actually derived from the arrangement.
- Where the arrangement has substantially standardised documentation and/or structure and is available to more than one relevant taxpayer without a need to be substantially customised for implementation.

This category of Hallmarks is kind of a "sweep vehicle". Under the last Hallmark of this category, the conjunctions "and/or" suggests that the use of standardisation, for example, in an engagement letter or in the description of the effect of a legal

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provision applied extensively, could be seen as sufficient to fall within the category.

b. *Specific Hallmarks linked to the MBT;*

Annex IV of the Directive Proposal also provides for specific examples of cross-border arrangements that will be reportable if they meet the MBT. These examples cover arrangements:

- whereby one participant takes contrived steps which consist in acquiring a loss-making company, discontinuing the main activity of such company and using its losses in order to reduce its tax liability, including through a transfer of those losses to another jurisdiction or by the acceleration of the use of those losses; or
- that have the effect of converting income into capital, gifts or other categories of revenue which are taxed at a lower level or exempt from tax; or
- which include circular transactions resulting in the round-tripping of funds, namely through interposed entities without other primary commercial function or transactions that offset or cancel each other or that have other similar features.

Unlike the General Hallmarks previously defined, these Specific Hallmarks require that the arrangements result in a particular outcome, which may not necessarily be a tax outcome. Still, this category remains very broad. For example, the conversion of an asset into an asset of another nature, such as the investment in an entity (i.e. contribution in cash or in kind in the share capital of a company in exchange for shares or not) is potentially captured by this category of Hallmarks while it is a very ordinary transaction.

c. *Specific Hallmarks related to cross-border transactions*

Under this category of Hallmarks, and contrary to the ones described above, the MBT does not necessarily need to be met for an arrangement to be treated as reportable.

An arrangement that involves deductible cross-border payments made between two or more associated enterprises will be reportable, if the MBT is met, and where at least one of the following conditions occurs:

- the recipient is resident for tax purposes in a jurisdiction that either does not impose any corporate tax or imposes corporate tax at the rate of zero or almost zero, or is included in a list of third-country jurisdictions which have been assessed by Member States collectively or within the framework of the OECD as non-cooperative; or
- the payment benefits from a full (and not only a partial) exemption from tax in the jurisdiction where the recipient is resident for tax purposes; or
- the payment benefits from a preferential tax regime in the jurisdiction where the recipient is resident for tax purposes.

An associated enterprise is a person who participates (i) in the management of another person by being in a position to exercise significant influence, (ii) in the control of another person through a holding that exceeds 25% of the voting rights, (iii) in the capital of another person through a right of ownership that, directly or indirectly, exceeds 25% of the capital or (iv) is entitled to 25% or more of the profits of another person.

Again, this category of Hallmarks, while described as specific, remains very broad. Any deductible investments through a collective investment vehicle ("**CIV**") benefiting from a divergent tax treatment (i.e. almost all), even if such preferential tax regime is not harmful, could fall into this category. If this were confirmed, this provision could result in a large amount of reports being filled, especially for CIVs held widely.

Even if the MBT is not met, certain arrangements made between two or more associated enterprises will be reportable. This is the case, for example, when the recipient of deductible cross-border payments is not resident for tax purposes in any tax jurisdiction.

The following arrangements will also be reportable under this category of Hallmarks without the need for the MBT to be met:

- arrangements in which deductions for the same depreciation on the asset are claimed in more than one jurisdiction;
- arrangements in which relief from double taxation in respect of the same item of income or capital is claimed in more than one jurisdiction;
- arrangements that include transfers of assets and where there is a material difference in the amount being treated as payable in consideration for the assets in those jurisdictions involved.

d. *Specific Hallmarks concerning automatic exchange of information and beneficial ownership*

Under this category of Hallmarks, there is no requirement that the MBT be met for an arrangement to be considered as reportable.

Anticipating the OECD Mandatory Disclosures Guidelines,

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this category relates to arrangements which may have the effect of undermining the reporting obligation under the laws implementing agreements on the automatic exchange of financial account information ("**AEoFAI**") such as DAC (as amended in 2014), the Foreign Account Tax Compliance Act ("**Fatca**") or the Common Reporting Standard ("**CRS**"). It presumes that undermining of reporting obligations is occurring notably when an arrangement results in at least the following:

- the use of an account, product or investment that is not, or purports not to be, a financial account, but has features that are substantially similar to those of a financial account;
- the transfer of financial accounts or assets to jurisdictions that are not bound by the AEoFAI with the State of residence of the relevant taxpayer;
- the re-classification of income and capital into products or payments that are not subject to the AEoFAI;
- the transfer or conversion of a financial institution or a financial account or the assets therein into a financial institution or a financial account or assets not subject to reporting under the AEoFAI;
- the use of legal entities, arrangements or structures that eliminate or purport to eliminate reporting of one or more Account Holders or Controlling Persons under the AEoFAI;
- arrangements that undermine or exploit weaknesses in the due diligence procedures used by financial institutions to comply with their obligations to report financial account information, including the use of jurisdictions with inadequate or weak regimes of enforcement of anti-money laundering legislation or with weak transparency requirements for legal persons or legal arrangements.

Under this category, the mere action of investing a financial asset (i.e. cash) in jurisdictions that are not bound by an AEoFAI could be subject to a reporting obligation under the Directive Proposal, even if these investments are realised for real economic or even charitable reasons. Under the second Hallmark of this category, for example, the transfer of funds by a Luxembourg entity to an entity located in Iraq or Libya, which helps refugees, could be captured. Indeed, it could be seen as a "transfer of financial assets" to jurisdictions that are not bound by the CRS with Luxembourg. This example demonstrates quite well the disproportionality of the rules set up by the Directive Proposal in the name of a blind and unreasonable fight against tax fraud and tax evasion.

This category of specific Hallmarks also targets arrangements involving a non-transparent legal or beneficial ownership chain with the use of persons, legal arrangements or structures:

- that do not perform a substantive economic activity supported by adequate staff, equipment, assets and premises; and
- that are incorporated, managed, resident, controlled or established in any jurisdiction other than the jurisdiction of residence of one or more of the beneficial owners of the assets held by such persons, legal arrangements or structures; and
- where the beneficial owners of such persons, legal arrangements or structures, as defined in Directive 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, are made unidentifiable.

e. *Specific Hallmarks concerning transfer pricing.*

Other examples of reportable cross-border arrangements are related to transfer pricing and include:

- an arrangement which involves the use of unilateral safe harbour rules;
- an arrangement involving the transfer of hard-to value intangibles between associated enterprises;
- an arrangement involving an significant intra-group cross-border transfer of functions and/or risks and/or assets, if the projected annual earnings before interest and taxes (EBIT), during the three-year period after the transfer, of the transferor or transferors, are less than 50% of the projected annual EBIT of such transferor or transferors if the transfer had not been made.

Which information will be reported?

If a cross-border arrangement is treated as reportable under the Directive Proposal, the information to be communicated to the tax authorities shall contain the following, as applicable:

- the identification of intermediaries and relevant taxpayers;
- details on the Hallmarks that make the cross-border arrangement reportable;
- a summary of the content of the reportable cross-border arrangement;
- the date on which the first step in implementing the reportable cross-border arrangement has been made or will be made;
- details of the national provisions that form the basis of the reportable cross-border arrangement;
- the value of the reportable cross-border arrangement;
- the identification of the Member State of the relevant taxpayer(s) and any other Member States which are

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likely to be concerned by the reportable cross-border arrangement; and
- the identification of any other person in the Member State, if any, likely to be affected by the reportable cross-border arrangement.

Who will be subject to the reporting duties under the Directive Proposal?

Principle

Cross-border arrangements falling within the scope of the Directive Proposal have to be reported by an EU intermediary, unless that intermediary is subject to professional secrecy, in which case the responsibility shifts onto the taxpayer concerned.

An intermediary is defined as any actor usually involved in designing, marketing, organising or managing the implementation of a reportable cross-border transaction or a series thereof, as well as those who provide aid, assistance or advice, such as:
- a tax adviser;
- an accountant; or
- a lawyer,

who designs and/or promotes tax planning schemes.

The following could also be treated as intermediary, "any person that knows, or could be reasonably expected to know, that they have undertaken to provide, directly or by means of other persons, aid, assistance or advice with respect to designing, marketing, organising, making available for implementation or managing the implementation of a reportable cross-border arrangement". As a result, any professional who has knowledge of a (planned) cross-border arrangement and who has undertaken to give assistance, even if he/she did not effectively give any advice in respect to the cross-border arrangement, could potentially fall within the scope of the Directive Proposal. Participating in a preliminary meeting, even if no engagement letter has been signed and further advice is given, could result in a professional being treated as an intermediary for the purpose of the Directive Proposal. This definition is so broad that all advisers should permanently check whether or not they are "assisting", directly or indirectly, a "reportable cross-border arrangement" and if so, to notify it to their client.

In order to be subject to disclosure under the Directive Proposal, the intermediary has to have an EU nexus based on either tax residence or a permanent establishment set-up in an EU Member State, through which the services related to the reportable arrangement are provided, or its place of incorporation, etc.

Once the local tax authorities have collected the information from either the EU intermediary or the taxpayer, they will be required to automatically exchange this information with the tax authorities of all other EU Member States through a central database.

Exceptions

If many intermediaries are involved in the same reportable cross-border arrangement, they all have the obligation to file information on that reportable cross-border arrangement. An intermediary shall be exempt from filing the information only to the extent that it has proof that the required information has already been filed by another intermediary. In this respect, it is not sufficient to simply prove that another intermediary has committed to report on a specific arrangement. Proof of the effective reporting is required. In practice, obtaining this proof will be difficult. This condition adds complexity to the reporting process with the potential result that many different reports, hypothetically with slightly different information given, would be filed for the same arrangement.

The disclosure obligation is not enforceable upon intermediaries subject to legal professional privilege or when there is no intermediary because, for instance, the taxpayer designs and implements a scheme in-house. In these cases, the disclosure obligation is shifted to the taxpayer that benefits from the arrangement, or to another intermediary. Intermediaries subject to legal professional privilege must nevertheless waive their filling obligation by notifying any other intermediary or the relevant taxpayer, of their disclosure obligations.

When will the reporting have to be performed?

Intermediaries will have to report to the local tax authorities within the following time limits:

1. Periodic reporting every **3 months** when cross-border arrangements are designed, marketed, ready for implementation or made available for implementation without a need to be substantially customised.
2. **Within 30 days** beginning on the day after the reportable cross-border arrangement is made available for implementation, or on the day after the reportable cross-border arrangement is ready for implementation, or when the first step in the implementation of the reportable cross-border arrangement has been made, whichever occurs first.

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3. Within 30 days beginning on the day after aid, assistance or advice is provided by an intermediary, directly or by means of other persons.
4. **By 31 August 2020** for reportable cross-border arrangements whose first step was implemented between the date of entry into force and the date of application of this Directive Proposal.
5. **Each of the years for which the taxpayers use their arrangements**, each relevant taxpayer may be required to file information about such use to the tax authorities.

The local tax authorities will have to automatically exchange the information received within one month from the end of the quarter in which the information was filed. The first information shall be exchanged by 31 October 2020.

Next steps and implications

Following the political agreement reached on the Directive Proposal, before becoming a final act, the Proposal will have to be formally adopted at one of the upcoming ECOFIN meetings. The new measures will have to be implemented into national law by 31 December 2019, and the new reporting requirements will apply from 1 July 2020.

Should an intermediary (or the taxpayer) not comply with its reporting obligations, penalties will apply, the amount of which will have to be determined by the EU Member States in such a way that it is proportionate and has a dissuasive effect. We can expect that the Luxembourg penalties applicable for intermediaries will be similar to the ones set up for CRS, Fatca or the exchange of information on demand (i.e. fine of EUR 250,000).

The Directive Proposal raises a lot of questions, notably on the practicability of the reporting. As the proposed Hallmarks have no materiality, and the MBT is abstract and quite subjective, even very simple and non-aggressive arrangements could fall within the scope of the reporting obligations under the Directive Proposal. We have no doubt that this will create a significant administrative burden for intermediaries.

Beyond the direct impact of the Directive Proposal on intermediaries and their clients, it will also generate a lot of work for the various tax authorities. Will they be in position to process all the collected information, to easily cross-check the appropriate information with the tax returns of the relevant taxpayers, and to efficiently make use of the exchanged information? Understaffed tax authorities will likely be flooded with information which they will find difficult to analyse. This effect has the potential to result in an inability to react or take measures to address arrangements that are, indeed, tax aggressive. This broad Directive Proposal may therefore sabotage the very objective it aims to achieve. Knowing that the information that has already been exchanged based on existing European and international regulations (i.e.: CRS and DAC) has not yet been decrypted and processed by some European Member States, the relevance of this Directive Proposal can be seriously questioned.

Taxpayers that intend to invest abroad (within or outside the EU) or that are in the process of investing abroad should seek advice from their tax adviser in order to analyse the potential impact of the new reporting requirements on their investments.

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FAIR TAXATION OF THE DIGITAL ECONOMY: A NEW TAX CHALLENGE

OUR INSIGHTS AT A GLANCE

- On 21 March 2018, the EU Commission issued two directive proposals aiming to ensure that tax laws "fairly" tax digital business activities. The first proposal aims at reforming the EU's corporate tax rules for digital activities while the second one aims at introducing an interim tax on certain revenue from digital activities.
- The first directive proposal aims at establishing a taxable nexus for digital businesses operating across borders without a physical commercial presence. It should be regarded as a new concept of permanent establishment to be added to the current ones, for the purposes of corporate tax in each Member State.
- The second directive proposal addresses the so-called Digital Services Tax. This interim tax will ensure that digital activities which are currently not effectively taxed, under the current corporate tax rules, would begin to generate immediate revenue for Member States.
- The legislative proposals will be submitted to the EU Council for adoption and to the EU Parliament for consultation. According to the proposals, new rules should be implemented into Member States's corporate income tax systems by 31 December 2019 at the latest. However, some Member States, such as Luxembourg, have already announced that they would not agree on the directive proposals if no agreement is reached at the OECD level.

The digitalisation of the economy is putting pressure on the international taxation system. Business models are changing and the existing corporate taxation rules are considered, by some States, as too archaic to handle such developments. In particular, the existing rules are no longer adapted to the contemporary context where online cross-border trading with no physical presence is an easy affair, where businesses largely rely on intangible assets that are hard to value from a transfer pricing point of view, and where user-generated content and data collection have become core activities for the value creation of digital businesses.

In 2015, the Organisation for Economic Co-Operation and Development ("**OECD**") considered this issue in the context of the OECD BEPS Project Action 1 "Addressing the Tax Challenges of the Digital Economy". In March 2018, the OECD delivered an interim report on the implications of digitalisation for taxation. At European level, the Commission adopted, on 21 September 2017, the Communication on "A Fair and Efficient Tax System in the European Union ("**EU**") for the Digital Single Market".This was followed on 19 October 2017 by the conclusions of the European Council which underlined the need for an effective and fair taxation system fit for the digital era.

As a result, on 21 March 2018, the EU Commission issued two directive proposals aiming to ensure that tax laws "fairly" tax digital business activities. The first proposal aims at reforming the EU's corporate tax rules for digital activities ("**DP 1**"). The second one aims at introducing an interim tax on certain revenue from digital activities ("**DP 2**"), pending a broader international initiative in light of the OECD BEPS Project Action 1.

Below, we explain in detail the main implications of these directive proposals.

DP1: A common reform of the EU's corporate tax rules for digital activities

Different options were discussed at the EU level in order to introduce a "digital tax". The first option involved the amendment

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of the rules for the Common Consolidated Corporate Tax Base proposal ("**CCCTB**"). The second one was the adoption of a directive on digital permanent establishment ("**PE**") and profit allocation principles, with adjustments to the CCCTB. However, the preferred long-term solution of the EU Commission described in the DP1 is a third option which combines the second option and adds a recommendation to change the rules vis-à-vis third countries.

Key Concept of PE

The current corporate tax rules are built on the principle that profits should be taxed where the value is created. The DP1 does not call this principle into question. However, the current rules were mainly conceived for traditional "brick and mortar" businesses and define the taxing right of a country on the basis of a physical presence in that country. Consequently, it fails to capture digital activities where physical presence is no longer a requirement for providing digital services.

The DP1 thus aims at establishing a taxable nexus for digital businesses operating across borders without a physical commercial presence (what DP1 refers to as a "significant digital presence" ("**SDP**")). It should be regarded as a new PE concept (i.e. a taxable "digital presence" or a virtual PE) to be added to the current ones, for the purposes of corporate tax purposes in each Member State ("**MS**").

Significant digital presence

The proposed rules for establishing a taxable nexus of a digital business in a MS are based on certain indicators of economic activity. A digital platform will be deemed to have a SDP in a MS if it fulfils **one of the** following criteria:

- It exceeds a threshold of EUR 7 million in annual revenue resulting from the supply of digital services to users located in a MS; or
- It has more than 100,000 users of one or more of the digital services located in a MS in a taxable year; or
- Over 3,000 business contracts for the supply of any such digital services are created between the company and "business" users in a taxable year.

According to the DP1, a digital service is a service that is delivered over the internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention[1], and impossible to ensure in the absence of information technology. Minimal human intervention is only required on the side of the supplier without any regard to the level of human intervention on the side of the user. A service will only be considered as requiring a minimal human intervention in situations where the supplier initially sets up a system, regularly maintains the system or repairs it in cases of problems linked with its functioning. However, in order to exclude a taxable nexus based on the place of consumption only, the mere sale of goods or services facilitated by using the internet or an electronic network will not be regarded as a digital service. Providing (paid) access to a digital marketplace for buying and selling cars would therefore be regarded as a digital service, but the sale of a car itself via the online platform would not.

Annual revenue resulting from the supply of these digital services shall be determined in proportion to the number of times devices are used in that tax period by users located anywhere in the world to access the digital interface through which the digital services are supplied.

A user shall be considered as located in a MS in a given tax period if the user uses a device in that MS during that tax period to access the digital interface through which the digital services are supplied. The MS where a user's device is used shall be determined by reference to the Internet Protocol (IP) address of the device or, if more accurate, any other method of geolocation.

This raises a few questions as to the way the annual revenue resulting from the supply of digital services to users located in a MS will be computed. Notably, the DP1 does specify how a specific revenue and/or value will be allocated to a particular digital service. However, all the various digital enterprises and platforms at stake have different e-business models and, therefore, different ways to be remunerated or create value. In addition, the allocation of revenues to the various MS relies on a very unprecise criterion. Indeed, despite the various existing e-business models, the allocation method outlined in the DP1 only takes into account the number of "clicks" to access a digital interface. It does not take into account the fact that the same user could have many devices, or transport his or her device regularly from one MS to another (even on the same day). Moreover, these criteria give the impression that the value is created by the simple fact that a device is used without taking into consideration the way and the period (i.e. frequency, time of connection, effective use/registration or "quick look / impressions", number of contracts concluded as a result of the "use", etc.) during which a device or a digital interface is used. Yet, if a "click" creates valuable data under certain e-business models (i.e. advertising), it is not necessary the case under others. Ironically, as the DP1 requires that a device is used "to access" the digital interface, one could wonder whether the intention of the user would be relevant, excluding inadvertent "clicks" from the computation.

The second criterion is also really broad. It does not differentiate between the user who connects once a month and the one who connects every day. The "digital footprint" of a business which has frequent users cannot be compared with businesses used by occasional users. We can also expect that almost all actors of the digital economy will reach the number of 100,000 users quite easily as the location is deemed to be established on a sole "access" basis and not a real use of a digital service. Without any definition of the word "access", the simple "click" on an icon could be considered as access while it does not create, in

[1] This definition corresponds to the definition of 'electronically supplied services' in Article 7 of the Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax, and includes the same kind of services

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itself any "user value". Furthermore, the threshold does not deal with the issue raised by a single user using many devices. If the number of users is determined on the basis of the number of devices used, again, this would not represent the real footprint of a business.

For the third criterion, a contract shall count as a business contract if the user concludes the contract in the course of carrying out business and if the user is resident for corporate tax purposes or has a PE in that MS. This criterion appears to be more objective and pertinent.

According to the 2018 OECD Interim Report on the implications of digitalisation for taxation, it appears that a number of countries have announced their intention to modify their domestic and/or treaty PE threshold based on such factors of "digital" or "online" presence. The measures implemented and enforceable so far include:

- the "Significant Economic Presence" test introduced in April 2016 by Israel's Tax Authority;
- the expanded definition of a "fixed place of business" for certain digital platforms introduced in 2017 by the Slovak Republic; and
- the new nexus rule based on the concept of "Significant Economic Presence", which is expected to come into effect in 2019 in India.

Another relevant development related to digitalisation includes the minority view expressed by some countries that the requirement of physical presence is no longer relevant for the application of the "service PE" definition in UN Model Tax Convention ("**UN MTC**"). It considers that the term "furnishing of services" used in the UN MTC provision refers to services "used" or "consumed" in the source jurisdiction, and as such can include services performed from a remote location provided the other requirements of the PE definition are met (e.g., duration test). The impact of this broad interpretation measure could potentially go far beyond online activities, to include any remote services supplied to a market (e.g., consultancy services, call centers).

Attribution of profit to a digital PE

Once the digital business is considered as taxable in a country because of its SDP, the profits generated by this business still need to be determined and attributed to that country. In the current corporate tax framework, transfer pricing rules are used to attribute the profit of multinational groups to the different countries based on an analysis of the functions, assets and risks within the value chain of the group. In the context of the taxation of business profits attributable to PE, a separate entity is hypothesised and the OECD Transfer Pricing Guidelines ("**OECD Guidelines**") apply by analogy. The OECD Guidelines also deal with the transfer pricing of intangibles, but in a quite complicated way. As the digital economy relies heavily on the contribution of end-users, intangible assets such as user data and advanced data analytics methods, the value of big data and the tendency towards "winner-takes-most" market structures rooted in the strong presence of network effects, the current rules should be amended to better capture value creation through a digital PE.

As a result, the DP1 changes how profits are allocated to or in respect of a SDP, for corporate tax purposes, in MS. The authorised OECD approach ("**AOA**") remains the underlying principle for attributing profits to a SDP. The determination of profits attributable to or in respect of the SDP shall therefore be based on a functional analysis, taking into account the assets used, functions performed, and risks assumed. The new rules confirm that in order to determine the functions of, and attribute the economic ownership of assets and risks to the SDP, the economically significant activities ("**ESA**") performed through a digital interface shall be taken into account.

The ESA performed by the SDP through a digital interface (and which are relevant to the development, enhancement, maintenance, protection and exploitation of the enterprise's intangible assets) include, inter alia, the following activities:

- the collection, storage, processing, analysis, deployment and sale of user-level data;
- the collection, storage, processing and display of user-generated content;
- the sale of online advertising space;
- the making available of third-party created content on a digital marketplace;
- the supply of any digital service not listed above.

Taxpayers shall use the profit split method unless the taxpayer can prove that an alternative method based on internationally accepted principles is more appropriate with regard to the results of the functional analysis.

Interaction with double tax treaties ("DTT")

The DP1 would enable MS to tax profits that are generated within their territory, even if a company does not have a physical presence there. This proposal will affect corporate taxpayers that are incorporated or established in the EU, as well as enterprises that are incorporated or established in a non-EU jurisdiction with which there is no DTT with the MS when a significant digital presence of the taxpayer is identified. In respect to corporate taxpayers incorporated or established in the EU, the provisions of the DTT between the relevant MS should nevertheless prevail on the local provisions transposing the DP1.

The DP1 does, however, not affect enterprises that are incorporated or established in a non-EU jurisdiction with which there is a DTT in force with the MS of the SDP. Indeed, where there is a DTT between a MS and a non-EU jurisdiction, the rules of the applicable DTT will override the proposed provisions on a SDP. This DP1 is thus part of a package that also includes a Recommendation by which the Commission is recommending MS to replicate the provisions included in the DP1 in the DTT with third countries. In the current context (i.e. 2017 US tax reform,

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new US import taxes, US refusal to sign the MLI), it is very likely that the USA will not agree to renegotiate their DTT as the digital tax will mainly impact US digital companies.

DP2: An interim tax on certain revenue from digital activities

Recent developments point out that a meaningful number of countries have taken actions outside the framework of income taxes to assert taxing rights over non-resident enterprises, such as foreign-based suppliers of digital products and services. These measures typically include sectoral turnover taxes targeted at (or including) revenue from online advertising services, such as India's Equalisation Levy, Italy's levy on digital transactions, Hungary's advertisement tax, France's tax on online and physical distribution of audio-visual content, and UK draft bill regarding the equalisation tax.

The DP2 addresses, as a simple interim solution, a levy based on revenue from digital activities in the EU, the so-called Digital Services Tax ("**DST**"). This interim tax will ensure that digital activities which are currently not effectively taxed, under the current corporate tax rules, would begin to generate immediate revenue for MS. The tax would also help avoid unilateral measures to tax digital activities in certain MS leading potentially to a motley patchwork of national responses which would be damaging for our Single Market.

Digital activities in scope of the DST

The DST will apply only to revenue arising from certain digital activities where is it considered that the participation of a user is essential for the business to carry out that activity and enables that business to obtain revenue therefrom.

The revenue that would not exist in its current form without user involvement would be that derived from the provision of any of the following services:

- services consisting in the placing of advertising on a digital interface targeted at users of that interface; as well as the transmission of data collected about users which has been generated from those users' activities on digital interfaces;
- services consisting in the making available of multi-sided digital interfaces to users, which may also be referred to as "intermediation services", allowing users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users.

Consequently, services by an entity to users through a digital interface consisting in the supply of digital content such as video, audio or text, are not to be regarded as intermediation services and should therefore be excluded from the scope of the tax. In such cases, it is less certain that user participation plays a central role in the creation of value for the business. This should be distinguished from the making available of a multi-sided digital interface through which users can upload and share digital content with other users, or the making available of an interface that facilitates an underlying supply of digital content directly between users. Other digital services are also excluded from the scope of the DST such as, for example, the supply of certain crowdfunding services, or services consisting in the facilitation of the granting of loans, by some regulated service provider.

Entities in the scope of the DST

Entities above both of the following thresholds qualify as taxable persons for the purposes of the DST:

- the total amount of worldwide revenue reported by the entity for the latest complete financial year for which a financial statement is available exceeds EUR 750,000,000; and
- the total amount of taxable revenue obtained by the entity within the European Union during that financial year exceeds EUR 50,000,000.

If the business belongs to a consolidated group for financial accounting purposes, the thresholds have to be applied with respect to the total consolidated group revenue.

The first threshold (total annual worldwide revenue) limits the application of the tax to companies of a certain scale, considered as easily engaging in aggressive tax planning, and ensures that smaller start-ups and scale-up businesses remain out of scope. The same threshold has been proposed in other EU initiatives, such as the CCCTB.

The second threshold (total annual taxable revenue in the EU), in contrast, limits the application of the tax to cases where there is a significant digital footprint at EU level in relation to the revenue covered by DST, in order to disregard differences in market sizes which may exist within the EU. However, despite the fact that the differences between market sizes existing within the EU are not taken into account for this purpose, they will have an impact on the proportion of an entity's total taxable revenue treated as obtained when determining the place where a digital activity is chargeable as it will be computed on the basis of the users. Does this seem like a fair playing field? This also raises the question of the potential loss-making digital activities that would be realised in one or more MS. If the input is globalised, the output should also be globalised without taking into account the differences in market sizes (i.e. the number of users). Depending on where the taxable person is established, the scenarios where DST liability may arise can involve (i) a taxable person established in a non-EU jurisdiction having to pay DST in a MS, (ii) a taxable person established in a MS having to pay DST in another MS, or (iii) a taxable person established in a MS having to pay DST in that same MS.

Revenue subject to DST

Revenues obtained from the monetisation of the user participation are subject to taxation, and not user participation in itself. However, user participation can contribute to the value

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of a business in several ways. The revenue resulting from the provision of each of the following services qualify as subject to DST:

- the placing of advertising on a digital interface targeted at users of that interface;
- the making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users;
- the transmission of data collected about users and generated from users' activities on digital interfaces.

The total gross revenue is subject to DST, net of value added tax ("**VAT**") and other similar taxes.

The DP2 mentions that in order to alleviate possible cases of double taxation where the same revenue is subject to the corporate income tax and DST, it is expected that MS will allow businesses to deduct the DST paid as a cost from the corporate income tax base in their territory, irrespective of whether both taxes are paid in the same MS or in different ones. The DP2 seems however not to require the DST deduction but leave it to the discretion of the MS. In addition, as the DST would probably not be classified as a "tax on income", but rather as a transaction-based tax that applies to the "amount of consideration" received (in principle not covered by DTT), it is unlikely to give rise to double tax relief in another jurisdiction under domestic law or a DTT. The DST may thus generate situations of double taxation for foreign enterprises already liable to corporate taxes in their country of residence.

Place of the DST chargeability

The DST will be applied at a rate of 3% on gross annual revenue in the EU derived from specific digital services, due in the MS(s) where the users involved are located. The DST will be chargeable in a MS on the proportion of taxable revenue, obtained by a taxable person in a tax period, that is treated as obtained in that MS. Taxable revenues shall be treated as obtained in a MS during that tax period if users of the taxable service are located in that MS during that tax period.

A user will be deemed to be located in a MS during a tax period if:

- the digital advertising appears on the user's device at a time when the device is being used to access a digital interface in that MS during that tax period; or
- the user uses his or her devices in a MS and accesses a digital interface.

In addition, the proportion of an entity's total taxable revenue that is treated as obtained in a MS shall be determined as follows:

- in proportion to the number of times an advertisement has appeared on users' devices in that tax period;
- in proportion to the number of users having concluded underlying transactions on the digital interface in that tax period;
- in proportion to the number of users holding an account for all or part of that tax period allowing them to access the digital interface;
- in proportion to the number of users from whom data transmitted during that tax period has been generated as a result of users having used a device to access a digital interface, whether during the reference tax period or during a previous one

As under the DP1, the physical location where a user's device is used shall be determined by reference to the Internet Protocol (IP) address of the device or, if more accurate, by any other method of geolocation.

As explained above, the reference to users and their use of/ access by their devices as the main criteria to taxing the digital economy will raise a lot of issues, and quite probably, situations of double taxation.

What's next?

According to the proposals, the DP1 and DP2 rules should be implemented into MS's corporate income tax systems by 31 December 2019 at the latest. The DP1 rules will be applicable from 1 January 2020, with respect to tax periods beginning on or after that date, while the DP2 rules will be applicable from 1 January 2020. It should be noted in this regard that the DP2 announces an interim measure but does not provide for a sunset date.

However, before being adopted, the proposals will need to overcome a few obstacles. The legislative proposals will be submitted to the EU Council for adoption and to the EU Parliament for consultation. Some MS, such as Luxembourg, have already announced that they would not agree on the DP1 and the DP2 if no agreement is reached at the OECD level. The EU will, in this respect, continue to actively contribute to the global discussions on digital taxation within the G20/OECD, and push for ambitious international solutions. However, reaching an international agreement is likely to be challenging notably because of the probable negative position on the topic by the United States

It has also been announced that the EU Commission stands ready to work with MS and the EU Parliament to examine how the provisions in this DP1 can be incorporated into the CCCTB. Furthermore, with respect to allocating the profits of large multinational groups, the formula apportionment approach in the CCCTB is expected to be adapted in order to effectively capture digital activities.

Implications

In the preamble of the proposals, it is written that "the criteria should ensure a comparable treatment in different Member

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States, irrespective of their size, and leave out trivial cases". However, it is clear that if the main criteria to give the taxing rights and to allocate profits to a specific State are only based on the number of users, smaller countries will be at a disadvantage as compared to larger ones and could never compete on their level. Where is the spirit of "fair playing field" in that? Such systems would arbitrarily favour large population economies, without taking into account the fact that user participation (that should be clearly defined) is not the only element creating value in the digital economy. Other elements such as the user data processing, the user data utilisation, the advertisement or website creation, etc. are also relevant to the value creation and could be located elsewhere. A question also arises as to whether it would make sense to limit the proposals below to BtoB transactions and not include BtoC transactions. This would limit the impact of the size of a State (which de facto disadvantages Luxembourg because of its low number of potential consumers) on the effect of the measures in question.

In addition, such proposals would undermine the long-standing transfer pricing principles, the assumptions on which the OECD Guidelines are based, and one of the key objectives of the BEPS Project as a whole: "better aligning taxing rights with economic activity". For example, the BEPS Project seeks to reallocate taxation rights from where the risks are contractually allocated, to where the risks are actually managed. It is difficult to see how the DP1 and the DP2 would achieve, and not hinder, this goal.

None of the proposals analysed could be approved as such. The weight of the number of users should be reduced and the criteria consistent with BEPS and currently used for transfer pricing and substance (non-user value creation, risk allocation, economic substance, physical substance...) should be taken into account in order to allocate, or give, the right to a MS to tax the digital activities in their countries.

Moreover, only the taxation of profits, and not of the turnover, should be considered. Such a charge on turnover would lead to the introduction of an additional tax system in an already complex international tax environment. It would indeed create a two-tier tax system - one for the "traditional economy" (profit allocation only) and additional one for the digital economy (turnover taxation). This would be neither neutral, nor fair. An interim turnover tax system will also be difficult to apply in practice (tax payable in many different jurisdictions, collection implications, etc.) and will create issues of over or double taxation. This would run counter to the underlying narrative to justify the introduction of the tax, which is to target supplies of cross-border digital services that are not subject to income taxation in the market jurisdiction under existing rules.

Lastly, it is interesting to note that in the absence of physical presence of a digital enterprise on the territory of a taxing State, such State will have to rely largely on the enterprise itself for the correct assessment of the taxes and their collection, which is for these purposes, assumed to know everything about all users (i.e. geolocation of each user). This will of course raise a lot of questions regarding the protection of individual privacy rights (i.e. Human rights, EU General Data Protection Regulation).

There is no doubt that the international tax system needs to be modernised in order to take into account the digitalisation of the economy. However, considering the above, further thoughts and time must to be given to this issue. However, this should be done outside the scope of the BEPS Project as the digitalisation of the economy is not tax evasion issue, but the inevitable result of the modernisation of our society.

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EU COURT OF JUSTICE RULES ON THE LIMITS OF ANTI-ABUSE RULES

OUR INSIGHTS AT A GLANCE

- On 20 December 2017, the Court of Justice of the European Union (CJEU) decided on two cases involving German anti-abuse legislation that denies a (partial) exemption or refund of withholding tax on distributions made by German companies to foreign parent companies, confirming the Court's previous jurisprudence.
- The CJEU analysed the conformity of the German anti-abuse provision in regard to both the restrictions imposed by the EU Parent-Subsidiary Directive and the freedom of establishment, finding the German provision too restrictive.
- The CJEU reconfirms that taxpayers are free to rely on their EU freedoms when structuring investments as long as the underlying contractual arrangements are not "wholly artificial arrangements" which do not reflect economic reality and the purpose of which is to unduly obtain a tax advantage.
- The case law of the CJEU provides for clear guidelines regarding the design and interpretation of anti-abuse provisions in an EU context, contributing to legal certainty in the post-BEPS era.
- On 4 April 2018, the German Ministry of Finance issued official guidance in response to the decision of the CJEU, but it remains to be seen how the German tax authorities will respond in practice.

On 20 December 2017, the Court of Justice of the European Union ("**CJEU**") decided on two cases involving German anti-abuse legislation that denies a (partial) exemption or refund of withholding tax on distributions made by German companies to foreign parent companies. This case law confirms the Court's previous jurisprudence and should have a significant impact on anti-abuse provisions implemented by several European countries. Evidently, this decision is of major relevance for Luxembourg companies holding participations in German and other European subsidiaries. This article provides a clear and concise overview of the cases under review, the anti-abuse provision in question and the limitations set by the CJEU on the scope of anti-abuse legislation in an EU context.

Introduction

Dividends distributed by a German capital company to a non-resident parent company are in general subject to German corporate income tax at a rate of 25% (plus 5.5% solidarity surcharge applied thereon). However, parent companies resident in EU Member States may benefit from a full withholding tax exemption in accordance with German tax law implementing the rules of the EU Parent-Subsidiary Directive. Moreover, the right of Germany to levy withholding tax on dividends may be restricted by tax treaties. So far, so good.

However, in practice, when German companies distribute dividends to non-resident parent companies, Paragraph 50d (3) of the German Income Tax Law (Einkommensteuergesetz, "EStG") provides for an anti-abuse provision that subjects the application of reduced or zero withholding tax rates on dividends to certain (excessive) conditions. Since its introduction in 2007, there have been serious doubts regarding the conformity of this rule with EU law as it did not tie on the "wholly artificial arrangement" criterion established in CJEU case law.

The Finance Court of Cologne (Finanzgericht Köln) referred two cases to the CJEU where § 50d (3) of the EStG was applied in order to have clarity whether this provision is in conformity

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with the EU Parent-Subsidiary Directive and primary EU law (freedom of establishment, etc.). By decision of the President of the CJEU of 6 April 2017, Cases C-504/16 and C-613/16 were joined for the purposes of the oral part of the procedure and the judgement.

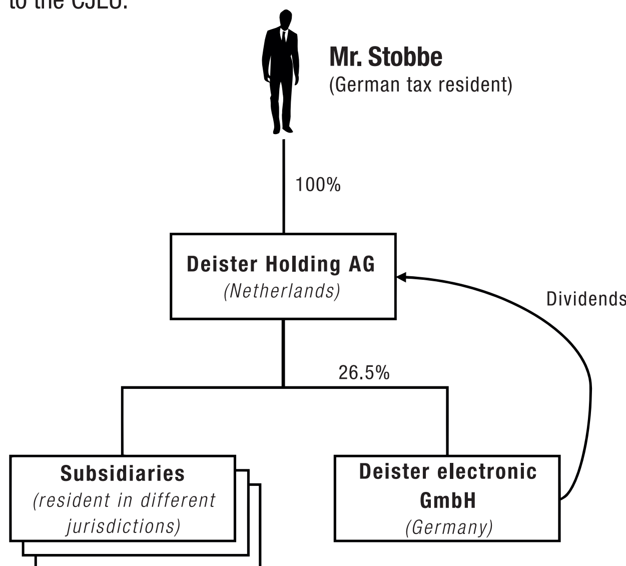
Key facts of the cases under review

Deister Holding AG (Case C-504/16)

Deister Holding AG (formerly Traxx Investments NV) was a Dutch company that held participations in several subsidiaries resident in different jurisdictions. Deister Holding AG financed its subsidiaries with a mixture of equity and shareholder loans.

As from 2005, the company owned a participation of 26.5% in Deister electronic GmbH, a company resident in Germany. As from March 2007, Deister Holding AG rented an office in the Netherlands and employed two people (in 2007 and 2008). The sole shareholder of Deister Holding AG was Mr. Stobbe, a German resident individual.

On 19 November 2007, Deister electronic GmbH paid dividends to Deister Holding AG. On this distribution, 25% German corporate income tax (plus solidarity surcharge) was withheld on behalf of Deister Holding AG. On 16 May 2008, Deister Holding AG applied for an exemption from German withholding tax which was rejected by the German tax authorities. Thereafter, Deister Holding AG brought an action against that decision before the Finanzgericht Köln (Finance Court of Cologne) on the grounds that Paragraph 50d (3) EStG is incompatible with the freedom of establishment and the EU Parent-Subsidiary Directive. The Court finally referred the case to the CJEU.



Juhler Holding A/S (Case C-613/16)

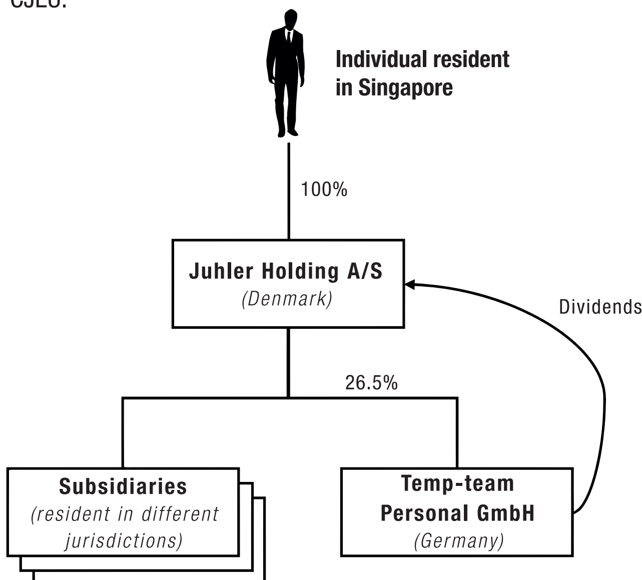
Juhler Holding A/S was a Danish company that was a wholly-owned subsidiary of Juhler Services Limited, a Cyprus company. The sole shareholder of Juhler Services Limited was an individual resident in Singapore.

Juhler Holing A/S held participations in more than 25 subsidiaries, some of which were resident in Denmark. The group was active in the area of personnel procurement services (one third of the volume of these services was rendered in Denmark). Since 2003, Juhler Holding A/S has held a 100% participation in temp-team Personal GmbH, a company resident in Germany.

As regards the activities and substance of Juhler Holding A/S, the following is mentioned:

- The company owned a property portfolio;
- It exercised financial control within the group so as to optimise the group's interest expenses;
- It monitored the performance of its subsidiaries;
- It had a phone line and an e-mail address;
- It was listed as a contact partner on the website of the group's homepage;
- It did not have its own office (if necessary, it used the premises as well as the other facilities and staff of other companies within the group);
- Its chief executive was also on the boards of various companies of the group.

In 2011, temp-team Personal GmbH paid a dividend to Juhler Holding A/S on which 25% corporate income tax (plus solidarity surcharge) was withheld. Juhler Holding applied for a refund of these taxes which was rejected by the German tax authorities. Thereafter, Juhler Holding A/S brought an action against that decision before the Finanzgericht Köln (Finance Court of Cologne) on the grounds that Paragraph 50d (3) EStG is incompatible with the freedom of establishment and the EU Parent-Subsidiary Directive. The Court referred the case to the CJEU.



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Overview of the German anti-abuse provision

The German anti-abuse provision as introduced in 2007 reads as follows:

"A foreign company has no entitlement to complete or partial relief under subparagraphs 1 or 2 to the extent that persons have holdings in it who would not be entitled to the refund or exemption if they earned the income directly, and

(1) There are no economic or other substantial reasons for the involvement of the foreign company; or
(2) The foreign company does not earn more than 10% of its entire gross income for the financial year in question from its own economic activity; or
(3) The foreign company does not take part in general economic commerce with a business establishment suitably equipped for its business purpose.

The circumstances of the foreign company shall be the sole decisive factor; organisational, economic or other substantial features of undertakings that are affiliated with the foreign company (Paragraph 1(2) of the Außensteuergesetz (Foreign Tax Act)) shall not be considered. A foreign company does not have its own economic activity if it earns its gross income from the management of assets or assigns its main business activities to third parties."

Hence, the entitlement to benefit from a withholding tax exemption or refund is precluded where (i) the non-resident parent company's shareholder would not be entitled to the exemption or a refund if they had received those dividends directly and (ii) one of the three conditions set-out in § 50d (3) of the EStG is met. The consequence of § 50d (3) is an automatic presumption of abuse or fraud without a possibility to rebut the presumption.

When determining whether the non-resident parent company has its own economic activity, current German legislation explicitly states that only the circumstances of the non-resident company are to be taken into account, whereas the organisational, economic and other substantial features of undertakings that are affiliated with that company are not to be considered. Thus, the structure and strategy of the group to which such a company belongs are not taken into account for the economic activity test.

Apart from the passive management of assets, the active management of an investment, holding or financing company would, in case of non-resident parent companies, not be regarded as own economic activity within the meaning of § 50d (3) of the EStG. Last but not least, the German tax authorities did not even have to evidence tax avoidance when denying the dividend withholding tax exemption.

In 2011, the German legislator slightly modified § 50d (3) of the EStG as a reaction to concerns that the provision was not in conformity with EU law.

Analysis of the CJEU decision

The CJEU analysed the conformity of the German anti-abuse provision in regard to both the restrictions imposed by (i) the EU Parent-Subsidiary Directive and (ii) the freedom of establishment.

EU Parent-Subsidiary Directive

According to Article 5 (1) of the EU Parent-Subsidiary Directive ("**PSD**"), the distribution of profits by a company that is resident in an EU Member State to a parent company that is resident in another EU Member State should be exempt from withholding tax. This exemption is meant to avoid double taxation, to ensure tax neutrality and to facilitate the grouping of companies at EU level.

Consequently, the PSD limits the sovereignty of EU Member States regarding the taxation of profits distributed by resident companies to a parent company resident in another Member State. Furthermore, Member States are not free to unilaterally introduce restrictive measures that would subject the right to exemption from withholding tax to various conditions.

Article 1 (2) of the PSD only allows Member States to introduce domestic or agreement-based provisions required for the prevention of fraud and abuse provided that these measures are appropriate and do not go beyond what is needed to achieve that objective. As an exception to the general rule laid down by the PSD, such measures are subject to a strict interpretation.

In other words, national legislation must be targeted to prevent conduct involving the creation of "wholly artificial arrangements" which do not reflect economic reality and the purpose of which is to unduly obtain a tax advantage. Thus, a general presumption of fraud and abuse can neither justify a fiscal measure which compromises the objectives of the PSD nor a fiscal measure which prejudices the enjoyment of a fundamental freedom guaranteed by the treaties.

When assessing the existence of fraud and abuse, tax authorities may not rely on predetermined general criteria. Instead, tax authorities have to carry out an individual examination of the whole operation at issue. The imposition of a general tax measure automatically excluding certain categories of taxable persons from the tax advantage, without the tax authorities being required to provide even prima facie evidence of fraud and abuse goes beyond what is necessary to prevent fraud and abuse.

The German anti-abuse provision clearly transgresses these guidelines and restrictions in many ways. When shares in a non-resident parent company are held by persons who would not be entitled to (partial) exemption from withholding tax if they received dividends directly from a subsidiary resident in Germany, Article 50d (3) of the EStG subjects the withholding

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tax exemption to the requirement that none of the three conditions laid down in that provision is met. Furthermore, the organisational, economic or other substantial features of undertakings that are affiliated with the non-resident parent company are not to be considered. In addition, a non-resident parent company is not considered to have its own economic activity if it earns its gross income from the management of assets or assigns its main business activities to third parties.

It is self-evident that § 50d (3) of the EStG is not specifically designed to target wholly artificial arrangements the purpose of which is to obtain an exemption from dividend withholding tax. Rather, this provision covers any situation where persons who would not be entitled to such an exemption (if they received the dividends directly) have holdings in a non-resident parent company.

However, according to the CJEU, the mere fact that such persons have holdings does not itself indicate the existence of a wholly artificial arrangement which does not reflect economic reality and whose purpose is to unduly obtain a tax advantage. Also, the PSD does not insert any restrictions linked to (i) the tax treatment of persons with holdings in parent companies resident in the European Union or (ii) the origin of such persons.

Moreover, when one of the three conditions laid down in § 50d (3) of the EStG is met, it establishes an irrebuttable presumption of fraud or abuse. The CJEU noticed that the three conditions, whether taken individually or as a whole, are not the right criteria to imply the existence of fraud or abuse. In particular, the PSD does not contain any requirement as to (i) the nature of the economic activity of companies falling within the scope or (ii) the amount of turnover resulting from those companies' own economic activity.

The fact that the economic activity of a non-resident parent company consists in the management of its subsidiaries' assets or that the income of that company results only from such management cannot *per se* indicate the existence of a wholly artificial arrangement which does not reflect economic reality.

In light of the above, the CJEU held that Article 1 (2) in conjunction with Article 5 (1) of the PSD preclude national legislation such as § 50d (3) of the EStG.

Freedom of establishment

The CJEU further analysed as to whether § 50d (3) of the EStG is in conformity with the freedom of establishment.

As a matter of principle, all measures which prohibit, impede or render less attractive the exercise of freedom of establishment must be considered to be restrictions to that freedom. Such restrictions are only permissible if they relate to situations which are not objectively comparable or if it is justified by overriding reasons in the public interest recognised by EU law.

However, in the present cases, the CJEU concludes that a non-resident parent company receiving a dividend from a German subsidiary is in a situation which is comparable to that of a German parent company. In these circumstances, it is further necessary that the restriction is appropriate for ensuring the attainment of the objective that it pursues and that it does not go beyond what is necessary to achieve this.

The CJEU states that the objective of combating tax evasion and avoidance, whether it is relied on Article 1 (2) of the PSD or as justification for an exception to primary law (i.e. the freedom of establishment) has the same scope. Therefore, anti-abuse provisions have to be targeted measures aiming at "wholly artificial arrangements" which do not reflect economic reality and the purpose of which is to unduly obtain a tax advantage.

Accordingly, EU Member States are free to protect their tax bases by way of anti-abuse rules which are exclusively directed at "wholly artificial arrangements" (see Cadbury Schweppes case C-196/04). Nevertheless, within the EU, restrictions can only be justified by the need to prevent tax avoidance when a specific anti-avoidance rule targets "wholly artificial arrangements aimed solely at escaping national tax normally due".

Thus, an abusive situation does not depend only on the intention of the taxpayer to obtain tax advantages (i.e. a motive test) but requires the existence (or absence) of certain objective factors. Amongst these objective elements, the CJEU emphasised the importance of the existence of an "actual establishment" in the host state (for example, premises, staff, facilities and equipment) and a "genuine economic activity" performed by the foreign company. Here, a company may even rely on staff and premises of affiliated companies resident in the same jurisdiction.

The notion of "genuine economic activity" should be understood in a very broad manner and may include the mere exploitation of assets such as shareholdings, receivables and intangibles for the purpose of deriving what is often described as "passive" income. The nature of the activity should not be compromised if such passive income is principally sourced outside the host state of the entity. Furthermore, the mere fact that a structure may help to shift income from a high-tax to a low-tax jurisdiction does not alone suffice to conclude that the structure is "abusive" (even if the structure has innovative features).

In addition, no specific ties or connections between the economic activity assigned to the foreign entity and the territory of the host state of that entity can be required by domestic anti-abuse provisions. Therefore, insofar as the EU internal market is concerned, the mere fact that an intermediary company is "active" in conducting the functions and assets allocated to it (rather than being a mere letterbox company) should suffice to be out of the scope of domestic anti-abuse rules or the PPT in tax treaties concluded between EU Member States.

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The objective of combating tax evasion and avoidance and that of safeguarding a balanced allocation of taxation powers between the Member States cannot, in the present case, justify an impediment to the freedom of establishment.

In addition, the CJEU noted that the origin of the shareholders of the parent companies does not affect the rights of companies to rely on the freedom of establishment. It does not follow from any provision of EU law that the origin of the shareholders of companies resident in the European Union, be they individuals or legal persons, affects the right of those companies to rely on that freedom.

In light of the above, the CJEU held that the German anti-abuse provision was violating the freedom of establishment.

Conclusion

Luxembourg is a prime holding location and a leading global centre for investment management within Europe. Therefore, the question as to whether Luxembourg companies involved in these investment structures may benefit from EU Directives and tax treaties concluded by Luxembourg with other EU Member States is of utmost importance. Unfortunately, anti-abuse legislation implemented by some EU Member States and the attitude of some foreign tax authorities have created unprecedented legal uncertainty in this respect.

The CJEU has now re-confirmed that taxpayers are free to rely on their EU freedoms when structuring investments as long as the underlying contractual arrangements are not "wholly artificial arrangements" which do not reflect economic reality and the purpose of which is to unduly obtain a tax advantage. The right of a Member State to protect its tax base against abusive arrangements is secondary. It follows that "tax jurisdiction shopping" is a legitimate activity in an internal market, even if the choice of the jurisdiction is principally based on tax considerations.

While § 50d (3) of the EStG has been slightly amended in 2011 with a view to ensure conformity with EU law, even the amended version of this provision does not comply with the requirements determined by the CJEU. It is interesting to note that the Finance Court of Cologne already referred a case relating to the 2011 version of § 50d (3) of the EStG to the CJEU. It is more than likely that the CJEU will decide that the new version is also incompatible with EU law. Importantly, the case law of the CJEU provides for clear guidelines regarding the design and interpretation of anti-abuse provisions in an EU context, contributing to legal certainty in the post-BEPS era. On 4 April 2018, the German Ministry of Finance issued official guidance in response to the decision of the CJEU, clarifying how the 2011 version of the German anti-directive/treaty-shopping rule should be applied. Ultimately, it remains to be seen how the German tax authorities will respond to the decision of the CJEU and taxpayers should be ready to claim their rights in front of the court if the standard set by the CJEU is not respected.

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EU LEGISLATIVE PROPOSALS TO FACILITATE THE CROSS-BORDER DISTRIBUTION OF INVESTMENT FUNDS

OUR INSIGHTS AT A GLANCE

- On 12 March 2018 the European Commission issued legislative proposals to amend the existing legal framework for the cross-border distribution of investment funds in the EU containing a Directive, which would have to be implemented into local legislation, and a Regulation which would have direct effect in EU Member States.
- These proposals aim at modifying the AIFM and UCITS Directives as well as introducing a regulation to standardise the requirements for cross-border distribution of both AIFs and UCITS in the EU in order to reduce regulatory burdens, reduce costs for fund managers and therefore increase the volume of funds marketed in the EU.
- While there are many positive aspects such as clear definitions, standardised guidelines, increased transparency and updated procedures, the proposals lack consistency regarding regulatory fees and have an extremely narrow scope of application regarding the definition of “pre-marketing”.
- ESMA holds a central role in implementing the cross-border regime, promoting EU-wide transparency and consistency for AIFs and UCITS marketing practices and requirements.

On 12 March 2018, in the context of the Capital Markets Union Action Plan and further to consultations conducted by the European Commission with national competent authorities (“**NCAs**”), industry associations and other stakeholders, the European Commission issued legislative proposals to amend the existing legal framework for the cross-border distribution of investment funds in the EU. These proposals contain a Directive, which would have to be implemented into local legislation, and a Regulation which would have direct effect in EU Member States (the “**Proposals**”).

These Proposals aim at modifying the AIFM and UCITS Directives as well as introducing a regulation to standardise the requirements for cross-border distribution of both AIFs and UCITS in the EU. The objectives of the Commission are to reduce regulatory barriers, including those pertaining to marketing requirements, regulatory fees, and administrative and notification requirements, as well as to reduce the costs for fund managers and to actively enhance the volume of funds that are marketed in the EU.

Positive aspects – harmonisation, facilitation and clarifications

In an attempt to harmonise disparate national regimes in the EU:

- a legal definition of “**pre-marketing**” is introduced for AIFs, EuVECA (European Venture Capital Funds) and EuSEF (European Social Entrepreneurship Funds), containing guidelines that are designed to enable fund managers to test investor appetite in relation to their product;
- **marketing communication** requirements should be harmonised for all type of funds, subject to further guidelines that will be available two years after the introduction of the regulation. A particular emphasis should be put on requirements applicable to online marketing communications. NCAs would continue to have the authority to make **systematic verification of marketing communications** for UCITS and AIFs that are marketed to retail investors. However, the Commission wants to discourage NCAs from using this verification process as a basis to add pre-conditions to marketing;

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- no **physical presence** (i.e. paying agent) would be required in Member States where funds are marketed, removing a few gold-plating requirements that some EU jurisdictions are still imposing. The Proposals only refer to the provision of **facilities** to UCITS investors and retail investors investing in AIFs for the processing of their subscription and redemption orders as well as payments. Investors should have access to offering documents and annual reports in a durable medium and in the relevant jurisdiction's official/accepted language – this will usually be done through (password-protected or not) specific online access;
- in a move to foster transparency, the fees and charges as well as the calculation methodologies applied by NCAs will have to be made public by these regulators (although this is already the case in most – but not all – of the EU jurisdictions). Furthermore, ESMA intends to centralise this information and propose an interactive tool allowing fund managers to simulate the costs of managing and marketing investment funds in EU Member States;
- deadlines and notification procedures for implementing changes to marketing/branching arrangements relating to UCITS will be aligned with applicable procedures under the AIFM Directive;
- a process is established to enable AIFs and UCITS fund managers to **discontinue marketing activities** once such activities have become insignificant in a specific jurisdiction. The suggestion of the Proposals appears however to add some requirements since fund managers would have to make a blanket offer to redeem free of charge all the interests/shares of relevant investors that are left in the relevant jurisdiction, notify their decision to withdraw their authorisation to market funds to the supervisory authorities of their home Member State, and ensure that no more than ten investors located in the relevant jurisdiction still hold an interest greater than 1% of the fund's assets under management.

What's missing – there is still room for improvement

We believe that some parts of the Proposals may still be improved:

- while setting a definition of "**pre-marketing**" under the AIFM Directive was expected by the industry in order to create harmony among the EU Member States' constructions and to create a level playing field, the scope of application of pre-marketing in the Proposals is extremely narrow. If pre-marketing is in any way restricted to providing information on investment strategies or investment ideas without being able to refer to an established AIF and if pre-marketing prevents fund managers from submitting draft offering documents (containing relevant disclaimers), fund managers' promotional activities will easily fall into a regulated marketing activity requiring full registration. Therefore, in some jurisdictions where pre-marketing has been forbidden, progress will be made. However, considering the current state of the Proposals, some jurisdictions may be subject to new restrictions. In any case, the fund manager cannot provide information enabling investors to commit or subscribe to shares, interests or units in an AIF;
- creating consistency on the way **regulatory fees** are applied in Europe is one of the objectives of the Proposals, but will only consist in broad guidelines while host Member States supervisory authorities will be in a position to charge fees that are proportionate to the supervisory activity they carry out in this context.

Central role of ESMA in the implementation of the new cross-border regime

The regulation empowers ESMA (European Securities and Markets Authorities) to develop draft **technical standards** to specify the information and procedures for the transmission of information between fund managers, NCAs and ESMA. The harmonisation of the administrative process will only see the light of day two years after the regulation enters into force, at the earliest.

ESMA will take a central role in promoting EU-wide transparency and consistency for AIFs and UCITS marketing practices and requirements. As set out above, ESMA will (i) centralise and review the NCAs' laws, regulations, administrative circulars and standards with regards to the verification of marketing material compliance, (ii) gather information on fees and charges, (iii) review the different EU Member States applicable legislation and administrative requirements to provide a comprehensive summary in plain language, customarily used in international finance, and also (iv) keep a register of all AIFs, UCITS and fund managers using the EU marketing/management passports.

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'BREXIT' – WHAT DOES IT MEAN FOR INDIRECT TAXES?

OUR INSIGHTS AT A GLANCE

- Following the 2016 referendum vote and the formal withdrawal notification, the UK should in principle not be subject to European legislation as from 30 March 2019.
- Businesses have to be aware of the indirect tax repercussions of Brexit, as detailed in an official Notice published by the EU Commission on 30 January 2018.
- Among the impacts: acquisitions of goods from the UK to the EU will be treated as imports on which VAT will have to be self-assessed by the EU importer; the granting of a VAT deduction right for EU-based financial and insurance companies who provide services to the UK; VAT MOSS registration no longer possible in the UK; new procedure for UK VAT refunds; possible custom controls and guarantee requests with the application of custom duties and the lodging of custom declarations.
- Businesses should therefore be cognizant of additional time, cost and administrative burdens that these changes may have on their operations and plan accordingly, consulting their tax adviser when necessary.

Following the 2016 referendum vote and the formal withdrawal notification, the United Kingdom ("**UK**") should in principle not be subject to European legislations as from 30 March 2019, the date from which the UK will become a "third country".

Aside from the uncertainties raised by the withdrawal of the UK from the European Union ("**Brexit**") and the domestic UK impacts on a system governed by the European Union ("**EU**") laws for over four decades, businesses also have to be aware of the indirect tax repercussions of Brexit. In this framework, the European Commission published on 30 January 2018 a Notice in relation to the indirect tax consequences of the withdrawal of the UK from the EU[3]. The key points of this Notice are highlighted hereunder.

Imports & exports v. intracommunity acquisitions & sales

After the UK officially leaves the EU, acquisitions of goods from the UK to the EU will be treated as imports on which VAT will have to be self-assessed by the EU importer. In some EU countries which do not have a simplification regime, import VAT paid will be due at EU customs by the importer leading to a pre-financing of the VAT.

As is the case with the current intracommunity supplies to the UK, exports from the EU territory to the UK will remain exempt from VAT.

Financial and insurance services to UK businesses – positive impact on the VAT recovery right for EU based companies

Brexit should have a positive impact on the VAT deduction right of EU-based financial and insurance companies. While financial and insurance services are VAT exempt without VAT deduction right for transactions between two EU based counterparts, these activities do grant a VAT deduction right when the customer is located outside of the EU.

As an example, a Luxembourg financing company granting loans to UK counterparts should be entitled to recover input VAT incurred in this respect, which would not be the case if the UK remained part of the EU.

[2] European Commission, Notice to Stakeholders, "Withdrawal of the United Kingdom and EU rules in the field of customs and indirect taxation", https://ec.europa.eu/taxation_customs/sites/taxation/files/notice_to_stakeholders_brexit_customs_and_vat_en.pdf
[3] European Commission, Notice to Stakeholders, "Withdrawal of the United Kingdom and EU rules in the field of customs and indirect taxation", https://ec.europa.eu/taxation_customs/sites/taxation/files/notice_to_stakeholders_brexit_customs_and_vat_en.pdf

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E-commerce - the end of the current UK Mini One-Stop Shop ("MOSS")

Telecommunications, broadcasting and electronically supplied services rendered to EU private customers (non-VAT taxable persons) are taxable for VAT purposes at the VAT rate applicable in the country where the customer is located.

In order to avoid the administrative burden of multiple VAT registrations, businesses are allowed to register with the VAT MOSS in one EU country in order to declare and to pay the VAT collected in the various EU countries.

Post Brexit, the current UK VAT MOSS will disappear. UK and non-EU businesses registered through the UK VAT MOSS will have to register with an EU-based MOSS.

VAT refunds – different procedure

Non UK-based businesses incurring VAT in the UK are, under some conditions, entitled to be refunded the UK VAT paid based on an electronic refund claim filed in the EU country where they are established.

After the UK officially leaves the EU and subject to reciprocity conditions, this process should be completed according to the procedure laid out by the Directive 86/560/EEC (arrangements for the refund of VAT to taxable persons not established in Community territory).

Customs

Post Brexit, the UK will be outside the scope of the EU customs territory. Therefore, movements of goods between the UK and the EU custom territory will likely be subject to customs supervision. This implies possible custom controls and guarantee requests, the application of custom duties and the lodging of custom declarations. In addition, prohibitions or restrictions on grounds of public policy or public security could apply to certain goods. This will have both cost and time implications for businesses involved in cross-border transactions with the UK.

If you would like to discuss the potential VAT impacts of Brexit on your business, please feel free to contact Thibaut Boulangé at thibaut.boulange@atoz.lu or Mireille Rodius at mireille.rodius@atoz.lu.

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