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INSIGHTS

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EDITORIAL

Greetings,

This year again, tax news did not take a summer holiday: in early August, the long awaited draft law introducing the new Luxembourg IP regime was released. As from 2018, the new BEPS-compliant regime will replace the former regime which had to be repealed following conclusions reached on IP regimes as part of the BEPS Action Plan. At the end of August, the Luxembourg tax authorities released a circular describing the practical application in Luxembourg of the mutual agreement procedures (MAPs) provided by the tax treaties signed by Luxembourg. Finally, Luxembourg has signed its first double tax treaty with Cyprus. This is the first Luxembourg tax treaty fully in line with the minimum standards defined in the BEPS Action Plan.

At EU level, after having implemented all BEPS measures in record time and even going beyond what the OECD countries had agreed to undertake in order to fight against BEPS (with ATAD 1, ATAD 2, automatic exchange of tax rulings, country-by-country reporting, etc.), the European Commission considered that more had to be done. On 21 June 2017, the Commission presented a wide-ranging proposal, which introduces new reporting requirements for potentially harmful or aggressive cross-border tax schemes. In its current form, the proposal means that taxpayers and their advisers can expect a wave of new (and largely redundant) reporting. Finally, we anticipate the general data protection rules to be implemented as from 2018 and analyse the far-reaching implications of these rules.

At global level, BEPS implementation keeps moving forward: while more and more countries sign the multilateral instrument aiming at implementing tax treaty related BEPS measures and some countries even start ratifying it, the OECD has been taking further steps. On 10 July 2017, the OECD published a revised version of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. One day later, the OECD Committee on Fiscal Affairs released the draft contents of the 2017 update to the OECD Model Tax Convention. The amendments to the OECD Model Tax Convention follow the various conclusions reached in the reports on several BEPS actions. In this issue, we analyse what these changes will mean for private equity funds.

We hope you enjoy these Insights.

The ATOZ Editorial Team

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NEW IP REGIME TO BE INTRODUCED IN 2018

OUR INSIGHTS AT A GLANCE

- As from 1 January 2018, Luxembourg taxpayers will be able to benefit, under certain conditions, from an 80% exemption regime applicable to income related to patents and copyrighted software
- The new regime will be BEPS-compliant, and consistent with the OECD report on Action 5 of the BEPS action plan which requires countries to adopt the modified nexus approach
- IP rights covered by the new Luxembourg regime are: patents defined broadly and copyrighted software. Trademarks and domain names are expressly excluded as they fall into the category of marketing-related IP assets
- In order to encourage R&D development, the amount of IP income that can benefit from the exemption depends on the amount of R&D expenditures incurred by the company and which gave rise to the IP income

On 4 August 2017, the text of the draft law introducing the new Luxembourg BEPS-compliant Intellectual Property (IP) regime was presented to Parliament. As from 1 January 2018, Luxembourg taxpayers will be able to benefit, under certain conditions, 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 fully exempt from net wealth tax.

The new regime will replace the former IP regime which had to be repealed as of 30 June 2016 since it was, as many other IP regimes, not in line with the so-called “modified nexus approach” defined in the OECD report on Action 5 of the BEPS Action plan and agreed upon at EU level.

Who will be able to benefit from the new regime? Which income from which IP assets will be covered and which conditions and limitations will apply? We provide answers to these questions based on the recently released draft law which may still evolve and change during the legislative process.

Who can benefit from the new IP regime?

As the former IP regime, the new regime will apply to all Luxembourg taxpayers. This means that the regime will be available to both individuals and companies. In addition, it will apply to Luxembourg permanent establishments of foreign companies located in a European Economic Area country (i.e. European Union, Iceland, Liechtenstein and Norway).

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 BEPS Action 5 report. Accordingly, 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, qualify for tax benefits under an IP regime.

In accordance with the draft law and in line with the conclusion reached in the BEPS Action 5 report, IP rights covered by the new Luxembourg regime are (i) patents defined broadly and (ii) 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 (same limitation in time to the application of the regime as under the former regime) as part of research and development (R&D) activities:

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(i) 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, orphan drug designations; and

(ii) Copyrighted software: software protected by copyright according to the internal and international provisions in force.

Trademarks and domain names are expressly excluded as they fall into the category of marketing-related IP assets.

How to compute the IP income which can benefit from the new regime?

The modified nexus approach defined in the BEPS Action 5 report aims to ensure that IP regimes provide benefits to taxpayers that engage in R&D since the intention of IP regimes is to encourage R&D activity.

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 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:

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

This means that if a company has only one single IP asset and incurs all of the expenditures to develop that asset itself, the nexus approach will allow 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 beneficial 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 draft law has defined these expenditures as follows:

Qualifying expenditures incurred to develop IP assets

Qualifying expenditures 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.

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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), 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" to expenditures that are included in qualifying expenditures (up to the amount of the taxpayer's overall expenditures). Hence, the up-lift may increase the amount of IP income that benefits from the new IP regime.

Overall expenditures incurred to develop IP assets

The 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

The 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 in 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 draft 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 a qualifying IP asset. In that case, the positive adjusted net qualifying income generated by a 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, will benefit from an 80% exemption; the effective taxation of the IP income will depend on the amount of income realised by the individual, due to the fact that the Luxembourg income tax rate is progressive.

As far as companies are concerned, the income receiving tax benefits will benefit from a corporate income tax (CIT) exemption. Since the taxable basis for municipal business tax (MBT) purposes is the same as the CIT basis, the 80% exemption will apply for both CIT and MBT purposes. Taking into account the CIT rate decrease taking place in 2018 and the additional MBT charge, the effective corporate tax rate applicable to the income receiving tax benefits will be 26.01 * 20% = 5.20%.

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

IP rights qualifying for the new IP regime will benefit from a 100% net wealth tax (NWT) exemption.

Next steps

The introduction of a new IP regime will be 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. IP regimes in countries participating in the BEPS project will become more and more similar in the future, given that they will all have to comply with the modified nexus approach. Therefore, it was important that Luxembourg make the right choices and exhaust all options provided in the BEPS report: the Luxembourg Government decided to adopt the optional 30% up-lift on qualifying expenses, which is good news for Luxembourg taxpayers.

The draft law also states that the transfer of a qualifying IP asset as part of a tax neutral transfer of business or autonomous part of business shall be realised as if no transfer had taken place. In addition, the scope of the regime might be expanded in the future as the concept of "IP assets functionally equivalent" to patents might evolve and be defined in future OECD publications. This new IP regime shall apply as from the 2018 tax year.

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TAX AUTHORITIES RELEASE CIRCULAR ON MUTUAL AGREEMENT PROCEDURES UNDER TAX TREATIES

OUR INSIGHTS AT A GLANCE

- On 28 August 2017, the Luxembourg tax authorities released a circular dealing with the mutual agreement procedures (MAPs) provided by Luxembourg tax treaties and their practical application in Luxembourg
- An MAP under a tax treaty is a procedure which calls for the competent authorities of the two Contracting States to solve an international tax dispute
- Access to an MAP is granted in case of application of anti-abuse provision based on either a tax treaty or internal law, as well as for transfer pricing matters, in any other situation of taxation not in line with a tax treaty and in cases of transfer pricing adjustments or profit allocation to a permanent establishment
- Taxpayers who wish to initiate an MAP are required to provide specific information and file the documentation listed in the Circular. However, the procedure can only be launched after an administrative measure has been taken, e.g. notification of a tax assessment

On 28 August 2017, the Luxembourg tax authorities released a circular dealing with the mutual agreement procedures (MAPs) provided by Luxembourg tax treaties and their practical application in Luxembourg. So far, Luxembourg legislation has not included any rules in this respect. However, given that it can be expected that these procedures will be launched more and more often in the future, it was time to provide some useful information to taxpayers. We present the main aspects of MAPs in Luxembourg.

An MAP under a tax treaty is a procedure which calls for the competent authorities of the two Contracting States to solve an international tax dispute. The procedure may apply:

- when a taxpayer disagrees with the position taken by the tax authorities (which it considers not in line with the tax treaty provisions),
- when the interpretation or application of a tax treaty provision raises some doubts or difficulties; or
- when the competent authorities wish to find an agreement to solve an issue of double taxation in a situation not covered by a tax treaty.

MAP access

Access to an MAP is granted in case of application of anti-abuse provision based on either a tax treaty or internal law. Furthermore, access is granted in transfer pricing matters, in any other situation of taxation not in line with a tax treaty as well as in cases of transfer pricing adjustments or profit allocation to a permanent establishment.

In Luxembourg, given that interest and penalties are not considered as taxes falling within the scope of tax treaties, they fall outside the scope of MAP procedures.

Competent authority

Any request for the initiation of an MAP must be sent to the competent authority of the Contracting State in which the taxpayer is a resident. As far as Luxembourg is concerned, the request has to be sent to:

- the executive committee (*Comité de direction*) of the direct tax authorities (*Administration des Contributions Directes*) for all MAPs,
- the economic division (*Division économique*) of the direct tax authorities for transfer pricing cases, or
- the division of the direct tax authorities in charge of international relations (*Division internationale*) for all other cases.

Formal requirements applicable to the MAP request

Taxpayers who wish to initiate an MAP are required to provide specific information and file the documentation listed in the Circular.

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They also have to indicate in their request whether an MAP was filed with the competent authority of the other Contracting State, whether the case at hand had already been handled in an advance tax clearance, an advance pricing agreement or a court case and whether an appeal was or will be lodged.

Given that an MAP can be initiated if the taxpayer considers that the measure(s) taken by one of the two Contracting States give raise to a taxation which is not in line with a the tax treaty, the procedure can only be launched after an administrative measure has been taken, e.g. notification of a tax assessment.

In most cases, the request has to be filed within 3 years following the date of the first notification of the administrative measure at stake. However, this time limit may vary between tax treaties. In a second step, Luxembourg has to inform, within 4 weeks, the competent authority of the other Contracting State that an MAP has been requested. The MAP will start either 1 week thereafter or within 5 weeks following the receipt of the MAP request from the taxpayer.

MAP procedures and other procedures

Both an MAP under a tax treaty and an internal proceeding can be initiated at the same time to handle the same issue.

- If the MAP ends and both Contracting States have managed to come to an agreement before a decision is taken by the Luxembourg court as part of the internal proceedings, the agreement reached by the authorities of both Contracting States can only be executed by Luxembourg to the extent that the taxpayer withdraws its appeal before the Luxembourg court.

- If the decision of the Luxembourg court as part of the internal proceeding is taken before the competent authorities of both Contracting States have reached an agreement, the decision ultimately reached by both authorities can only be executed by Luxembourg to the extent that it is not at the disadvantage of the taxpayer compared to the outcome reached in the internal proceeding. In other words, an MAP outcome cannot be less favourable than the one concluded by the Luxembourg court.

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SIGNATURE OF THE FIRST DOUBLE TAX TREATY BETWEEN LUXEMBOURG AND CYPRUS: WHAT WILL THE IMPACT BE ON CROSS BORDER STRUCTURING?

OUR INSIGHTS AT A GLANCE

- On 8 May 2017, Luxembourg and Cyprus signed their first double tax treaty
- In order to address some forms of treaty abuse, the double tax treaty contains a principal purpose test under which a tax treaty 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
- In Luxembourg, collective investment vehicles in corporate form such as UCIs in SICAV or SICAF form, SICAV-SIF/SICAF-SIF, RAIFs in corporate form as well as fiscally opaque SICARs should be entitled to tax treaty benefits

Introduction and Background

On 8 May 2017, Luxembourg and Cyprus signed their first double tax treaty ("DTT"). Through this tax treaty, both countries aim to strengthen their economic and commercial relationship. While Cyprus broadens its tax treaty network as Luxembourg was one of the few EU countries with which it had not yet signed a double tax treaty, Luxembourg fills the only remaining gap in its network of tax treaties with EU Member States.

On 7 June 2017, both Luxembourg and Cyprus also signed the multilateral convention (the "MLI") to implement tax treaty related measures aimed at preventing Base Erosion and Profit Shifting ("BEPS"). However, neither of the two States listed the Luxembourg-Cyprus DTT as a convention covered by the MLI given that the lists of covered tax treaties only contain tax treaties in force. As a result, once ratified, the MLI will not modify the Luxembourg-Cyprus DTT. However, the DTT already provides for the OECD's BEPS recommendations. In addition, the DTT generally follows the OECD Model Convention and includes the latest international standards with regard to exchange of information.

To the extent the ratification process is completed by both Luxembourg and Cyprus before the end of 2017, the DTT will apply as from 1 January 2018.

This article will examine the most relevant clauses of the DTT and their impact on tax structuring, both from a Luxembourg and a Cyprus point of view.

Principal Purpose Test

In order to address some forms of treaty abuse, the DTT contains a principal purpose test ("PPT") in accordance with Actions 6 and 15 of the BEPS Action Plan and in line with the guiding principle of paragraph 9.5 of the Commentary included in the draft contents of the 2017 Update to OECD Model 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). The fact that the wording "one of the principal purposes" has been chosen instead of wordings such as "sole purpose", "essential purpose" or "predominant purpose", makes it easier for the tax authorities to establish that the subjective test is met.

Despite the fact that the subjective test, as defined above, would be met, a DTT benefit would only be granted in the case where the taxpayer can prove that granting such benefit, in the circumstances at hand, is still in accordance with the object and purpose of the relevant provisions of the DTT (objective test). The objective test is not easy to interpret and, in practice, it might be difficult to determine what the object and purpose of the DTT provisions are. It is therefore recommended to seek advice from a tax adviser when setting up cross border structuring.

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Resident covered by the DTT - Collective investment vehicles

The DTT defines a "resident of a Contracting State" for the purposes of the Convention as any person, including a collective investment vehicle, who, under the domestic laws of that State, is liable to tax in that State by reason of domicile, residence, place of management or any other criterion of a similar nature. For legal persons, in case of conflict of residence (i.e. in case they are considered as a resident of both Luxembourg and Cyprus), they are considered as resident in the country in which they have their place of effective management. A person cannot be considered a "resident of a Contracting State" if such person is considered to be a tax resident but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State.

For the purpose of the DTT, a collective investment vehicle is considered as a resident if it is liable to tax therein by reason of its domicile, residence, place of management or any other criterion of a similar nature. A collective investment vehicle is also considered as liable to tax if it is subject to the tax laws of the Contracting State concerned, but is exempt from tax only if it meets all of the exemption requirements specified in the domestic tax laws of that State. A collective investment vehicle is deemed to be the beneficial owner of any income it receives.

From a Luxembourg perspective, this means that collective investment vehicles in corporate form as referred to in article 159 of the Income Tax Law (i.e.: UCIs in SICAV or SICAF form, SICAV-SIF/SICAF-SIF, RAIFs in corporate form as well as fiscally opaque SICARs) should be entitled to DTT benefits. On the contrary, collective investment vehicles treated as tax transparent for Luxembourg tax purposes (i.e.: UCIs or SIF set up as FCPs) will not be able to benefit from the DTT provisions. However, if the tax transparency of the entity is recognised, investors may be protected under the double tax treaty concluded between the investor country of residence and the country of the source income.

Similar provisions also apply for Cyprus purposes, where any form of collective investment vehicle in corporate form such as limited liability companies or public companies with management and control in Cyprus would be entitled to benefit from the DTT provisions, whilst tax transparent entities such as partnerships would not be entitled to these benefits.

Income from investments in immovable properties and movable assets

• Real estate

Any income derived by a resident of a Contracting State from the direct use, letting, or use in any other form of immovable property situated in a Contracting State may be taxed in the latter Contracting State. The right to tax of the State of source has priority over the right to tax of the other State and also applies in the case of an enterprise, where income is only indirectly derived from immovable property. To avoid double taxation of the foreign real estate income of its residents, Luxembourg will exempt such income and Cyprus will grant a tax credit for the foreign tax.

• Dividend

Under the DTT, dividends can be taxed both by the source State and by the State of residence of the beneficiary. However, the treaty caps the withholding tax rates that could be levied by the foreign source State as follows:

- 0% in the case where the beneficial owner is a Company other than a partnership which holds a participation of at least 10% in the paying company;
- 5% in all other cases.

Consequently, the DTT provides (1) for a general withholding tax rate which is lower than the domestic general withholding tax rate of 15% in Luxembourg and 17% in Cyprus, and (2) for a withholding tax exemption under less restrictive conditions than the ones applicable under either the Luxembourg participation exemption regime (as no holding period is required), or the Cyprus participation exemption regime (as no minimum taxation and no activity condition is required).

To avoid double taxation of the foreign dividend received by their residents, Luxembourg will grant a tax deduction equal to the tax paid in Cyprus, and Cyprus will grant a tax credit.

• Interest and royalties

According to the DTT, interest and royalties are only taxable in the Contracting State in which the recipients of the income are resident. Therefore, no withholding tax can be withheld in the foreign source State. For interest income, the DTT makes this rule subject to the legal acts of the European Union. However, under their domestic tax laws, neither Luxembourg nor Cyprus levy withholding tax on interest or on royalties paid to tax residents in the other country.

Capital gain on investments in immovable properties and movable assets

Pursuant to the DTT, capital gains on immovable properties located in a Contracting State may be taxed in that State, whereas capital gains on shares are taxable only in the State of which the alienator is a resident. The DTT provides, however, that gains derived from the alienation of shares deriving more than 50% of their value directly from immovable properties ("real estate-rich") may be taxable in the State where the immovable property is located.

Therefore, it appears that if the value of the real estate-rich

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company is indirectly (and not directly) derived from immovable property, capital gains on the shares held in such companies remain taxable only in the State of which the alienator is a resident. Consequently, subject to the PPT, the capital gain realised on the sale of the shares in the parent company of a real estate-rich subsidiary should be taxable only in the State of which the alienator is a resident.

To avoid double taxation of capital gains realised by their residents on the disposal of immovable properties and movable assets, Luxembourg will exempt such income and Cyprus will grant a tax credit for foreign tax.

Conclusion

The DTT is a new element in international structuring. To elaborate further on the impact which the DTT might have on your existing business or to discuss the new business opportunities that may arise between those two countries, please contact Petya Dimitrova at petya.dimitrova@atoz.lu or Marie Bentley at marie.bentley@atoz.lu.

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PROPOSAL FOR NEW TRANSPARENCY RULES FOR INTERMEDIARIES: EXCHANGE INFORMATION (AGAIN)

OUR INSIGHTS AT A GLANCE

- In June of this year, the European Commission published a proposal aiming at requiring intermediaries to report certain cross-border arrangements in order to facilitate the automatic exchange of information between EU member states
- Where the intermediary is entitled to a legal professional privilege under its national law, the responsibility will then be shifted onto the taxpayer. Equally, the taxpayer will have the responsibility to file the same information where there is no such intermediary
- For information to be filed with the competent tax authorities, the cross-border arrangement has to be considered "reportable", meeting at least one of the hallmarks (such as a main benefit test) set out in the proposal
- We feel that the rules contained in the proposal go well beyond any proportionality principle, invite the risk of creating substantial legal uncertainty for taxpayers and due to their extremely wide scope, are likely to capture all cross-border arrangements which will inevitably result in information overload both on the taxpayers' and intermediaries' end, but also on the part of the competent tax authorities

On 21 June 2017, the European Commission published a proposal (the "Proposal") for a Council directive that aims at amending Directive 2011/16/EU by imposing an obligation on intermediaries to report any cross-border arrangement which contains one or more of the "hallmarks" set forth in the Proposal to the competent tax authority so that the latter be in a position to automatically exchange that information with other EU Member States (the "Member States").

Background

It is now well established that one of the key political priorities of the European Union (the "EU") is to tackle tax avoidance and evasion so as to create a fairer single market amongst the various Member States.

The Proposal aims at once again amending Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation that repealed Directive 77/799/EEC and which has already been amended a fairly significant number of times:

- with Directive 2014/107/EU of 9 December 2014 regarding financial account information and common reporting standard;
- with Directive 2015/2376/EU of 8 December 2015 regarding the mandatory exchange of cross-border rulings and advance pricing arrangements; and
- with Directive 2016/881/EU of 25 May 2016 on country-by-country reporting.

In parallel, another proposal for amending the Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches was published on 12 April 2016. It proposes setting up a public country-by-country reporting so that information relating to tax paid and where the profits are made by large multinational enterprises would be publicly made available.

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The Proposal to amend Directive 2011/16/EU which was published by the Commission on 21 June 2017 is therefore the latest instrument that is part of the broader tax transparency package. This is a reaction to scandals such as the Panama papers and LuxLeaks, as well as the more recent Malta papers.

This article will address the origins of the Commission's Proposal, and the scope of the proposed new rules.

Origins of the Proposal

The European Parliament has called for a tougher stance on intermediaries that assist in tax evasion schemes whilst Member States have suggested that the Commission consider initiatives to legislate on the mandatory disclosure rules which stem from Action 12 of the base erosion and profit shifting ("BEPS") project in order to introduce more effective disincentives for intermediaries that assist in tax evasion or avoidance schemes.

Whilst neither the Proposal nor the Commission Staff Working Document - Impact Assessment accompanying the Proposal (the "Working Document") - provide for a clear definition of what constitutes tax avoidance and tax evasion, the Commission Staff Working Document considers that aggressive tax planning includes taking advantage of mismatches in the interaction between two or more tax systems for the purposes of reducing the overall tax liability of a taxpayer of group of companies. Such a working premise is, in the author's view, flawed in that it puts the sole burden of responsibility onto the taxpayer while disregarding an important part of the equation: Member States remain sovereign when it comes to legislating in direct tax matters. This therefore inevitably results in multiple pieces of domestic legislation which may all aim at addressing the same legal issue and/or which have the same legislative intent. Any attempt to achieve uniformity amongst these various legislations can therefore only be utopian and, as such, this may involuntarily and unknowingly result in mismatches in the interaction between two or more tax systems.

The Working Document further considers that aggressive tax planning includes taking advantage of the technical features of a tax system and concedes that a key characteristic of these aggressive tax planning practices usually involves strictly legal arrangements which contradict the intent of the law. One should question why the law and its technical features were not originally drafted in a way that is clear enough so as to ensure that no misunderstanding can occur in so far as the intent of law is concerned, and that it does not contain any of those technical features which taxpayers could take advantage of. The Proposal would therefore aim at addressing each Member State's apparent inability to precisely legislate, and more fundamentally would imply that EU law would indirectly take over in the field of direct taxation using article 115 of the Functioning of the European Union as an intrusion tool.

The Working Document further analysed the current mandatory disclosure regimes in jurisdictions located both within and outside the EU. Whilst all have their own specificities (and hence inherent mismatches), one common denominator amongst them is that none of these national regimes covers cross-border schemes. It is with these guiding principles that the Commission prepared the Proposal.

Scope of the proposed new rule

The rules set out in the Proposal will oblige Member States to take the necessary measures to require intermediaries to file information with the competent tax authorities on a reportable cross-border arrangement or series of arrangements within five working days beginning on the day after the reportable cross-border arrangement or series of arrangements is made available for implementation. Where the intermediary is entitled to a legal professional privilege under its national law, the responsibility will then be shifted onto the taxpayer. Equally, the taxpayer will have the responsibility to file the same information where there is no such intermediary.

The information so received will then be automatically exchanged by the competent tax authority on a regular basis with all other Member States.

What is a cross-border arrangement?

A cross-border arrangement is an arrangement or series of arrangements in either more than one Member State or a Member State and a third country where at least one of the following conditions are met: (i) not all the parties are resident for tax purposes in the same jurisdiction, (ii) one or more of the parties is simultaneously resident for tax purposes in more than one jurisdiction, (iii) one or more of the parties carries on a business in another jurisdiction through a permanent establishment and the arrangements form part or the whole of the business of the permanent establishment or (iv) the arrangements have a tax-related impact on at least two jurisdictions. This definition is consequently not subject to a separate cumulative requirement that there be a tax impact on at least two jurisdictions, which therefore results in an extremely broad scope of what may constitute a cross-border arrangement. It is therefore not entirely unlikely that even a wholly domestic arrangement could meet the definition. Therefore, one may anticipate that most, if not, all cross-border

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transactions will likely be captured by this definition thereby substantially increasing the potentiality of reporting volume.

What is a reportable cross-border arrangement?

For information to be filed with the competent tax authorities, the cross-border arrangement has to be a reportable one, that is to say one that satisfies at least one of the hallmarks set out in the annex IV to the Proposal. These hallmarks are split into two categories: (i) general hallmarks and (ii) specific hallmarks. General hallmarks and category B specific hallmarks have to meet a main benefit test. This test will be satisfied where the main benefit of an arrangement or of a series of arrangements is to obtain a tax advantage if it can be established that the advantage is the outcome which one may expect to derive from such an arrangement. This definition is in the author's view circular and suggests that the mere fact that there is an advantage which may have been deliberately made available by the relevant Member State as an outcome to an arrangement suffices to conclude that the main benefit is to obtain that advantage, and that as such would not prevent the arrangement from being reportable. This is deeply disturbing from an interpretational perspective and invites the risk of bringing a complete lack of legal certainty to taxpayers, although one of the key objectives of the Working Document when designing the disclosure regime was to ensure legal certainty about which types of schemes or arrangements would be disclosed to the tax authorities so that the disclosure regime would be efficient.

Without going into detail for each hallmark, hallmark B1 suggests that any loss utilisation – even by the very taxpayer that generated it – would become a reportable cross-border arrangement. Companies, in the same way as finance generally, encounter cycles where they are loss-making at some point, and eventually profit-making at another. Yet, this hallmark implies that companies that are utilising their own losses to offset taxable profit – which is probably a common tax concept amongst a majority of jurisdictions worldwide, albeit with local specificities, would be carrying out a potentially aggressive tax arrangement. The Working Document further suggests that it will not impact small and medium enterprises, grounding its reasoning on the fact that solely multinational enterprises are engaged in potentially aggressive tax planning arrangements. One may, for example, assume that a start-up company that operates cross-border that has yet to reach a profitable status will therefore be captured by the rules, thereby totally contradicting the results of the research that was performed as summarised in annex 4 of the Working Document. Not only would this contradict the intent of the Proposal, but it would further constitute a rather significant hindrance to the European economy by involuntarily putting too high a burden on all market players, including notably small and medium enterprises. Such an approach could, in the longer run, annihilate the very purpose of the Proposal – which is to establish a fairer and deeper single market amongst the various Member States – as it would clearly result in rendering European economy less competitive. Category E specific hallmark on transfer pricing is once again very wide in that it captures everything that is not compliant with the arm's length principle.

The hallmarks of the Proposal have been presumably widely drawn so as to facilitate achieving the aim of this new tax transparency initiative, an initiative whose goal is to ensure that Member States receive an early warning of potentially aggressive tax planning arrangements so that they may be in a position to assess their potential risks and legislate accordingly, but this imprecise drafting is likely to result in complete legal uncertainty.

When does the report have to be made?

The Proposal provides a very tight deadline within which to file the information. Indeed, information will have to be filed within five working days beginning on the day after the reportable cross-border arrangement or series of arrangements is made available for implementation to a taxpayer where the intermediary files or, where the responsibility shifts onto the taxpayer, within five working days after the first step of the implementation. The reporting will therefore clearly be an ex post reporting although one of the key objectives of the Proposal is to obtain timely and early information about the arrangements, preferably ex ante, so that Member States may react quickly and accordingly.

Closing remarks

The Proposal further has to be considered from a proportionality perspective. The Working Document concludes that the Proposal is in line with the proportionality principle on the basis that (i) the proposed rules are limited to addressing potentially aggressive tax planning schemes containing a cross-border element and (ii) that the imposition of penalties for non-compliance with national provisions that implement the proposed Directive into national law will remain under the sovereign control of Member States. However, it has to be questioned whether the wide definition of what constitutes a reportable cross-border arrangement could be seen as being disproportionate, for it could technically encompass a wide array of schemes which (i) may not necessarily have a tax impact in more than one jurisdiction (the Proposal targets

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potentially aggressive tax planning arrangements whereas the very existence of one should be a, if not the, fundamental principle underlying the Proposal) and (ii) may not necessarily be illegitimate or illegal.

In addition, the fact that imposition of penalties are left to national discretion would presumably imply that the taxpayer remains entitled to an effective judicial remedy as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms as well as Article 47 of the Charter of the Fundamental Rights of the European Union because the national penalties would result from an obligation imposed by an EU Directive. This was judged by the European Court of the European Union on 16 May 2016 in the case C-682/15, Berlioz Investment Fund SA vs. Directeur de l'Administration des Contributions Directes. The question here is how such a fundamental right could be guaranteed in the specific context of the mandatory exchange of information.

Moreover, due to the recent developments in this field, namely the various amendments to the Council Directive 2011/16/EU together with Directive 2016/1164/EU laying down rules against tax avoidance practices that directly affect the functioning of the internal market as amended by the Anti-Avoidance Directive II which was formally adopted by the EU Council on 29 May 2017, it is questionable whether EU Member States do not already have the necessary tools to combat tax evasion and could proceed, where necessary, to changes in their domestic legislation to secure their fiscal revenues. Moreover, in light of the wide definition of "reportable cross-border arrangement" set forth in the Proposal, it is doubtful that the competent tax authorities will have the necessary staff to review all filed reportable cross-border arrangements.

Finally, from a strict cost-benefit analysis, the Working Document suggests that the Proposal should not bring any additional burden or cost onto intermediaries or taxpayers, or even tax authorities. Indeed, while it is conceded in the Working Document that the impact on total tax loss is difficult to measure given the nature of tax avoidance and evasion, the Proposal works on the assumption that intermediaries would simply have to share the notes which are being prepared for their clients. This assumption is fundamentally erroneous as files which are being exchanged between taxpayers and their advisers probably contain information which goes well beyond the simple arrangement that is intended to be implemented (and is certainly one of the reasons why this information is legally privileged).

Conclusion

The Commission has been very active in the past recent years to propose legislative instruments that would enhance transparency within the EU so as to combat tax avoidance and tax evasion. These various initiatives have received very positive feedback from taxpayers and intermediaries alike. The Proposal is the latest publication in this regard and aims at addressing technical points which the previous legislation apparently did not address. However, its effects – under the current proposed drafting – are likely to attract fairly negative feedback from market players. The rules that are contained therein go well beyond any proportionality principle, invite the risk of creating substantial legal uncertainty for taxpayers and due to their extremely wide scope, are likely to capture all cross-border arrangements which will inevitably result in information overload both on the taxpayers' and intermediaries' end, but also on the part of the competent tax authorities. The risk of information overload gives way to a much greater danger of seeing this disclosure regime become entirely useless as it would lack a key fundamental element: legal certainty for the taxpayer. It would therefore be advisable for the Commission to reconsider this Proposal and possibly assess beforehand whether the existing tools that Member States possess are not already sufficient to achieve the goals which are being set.

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GETTING DATA PRIVACY RIGHT

OUR INSIGHTS AT A GLANCE

- Coming into effect at the beginning of 2018, the General Data Protection Regulation (GDPR) is the new EU legal framework for the protection of natural persons with regard to the processing and free movement of their personal data
- Private equity (PE) firms, as they by nature process personal data from a variety of sources, will be affected by this regulation
- The requirements entail ensuring a lawful, fair and transparent processing of personal data and guarantee its integrity and confidentiality, minimising the data collected to what is necessary and limit its processing to the purpose for which it was collected and keeping the data up to date and store it only for as long as necessary
- Each PE firm must perform a gap analysis of its current personal data processing practices and take all appropriate measures to comply with the GDPR. In addition to completing its own audit, the PE firms should also consider whether the funds they manage and their portfolio companies' practices are in line with the new rules

Private equity houses have eight more months to upgrade their data privacy practices and ensure full compliance with the EU General Data Protection Regulation[1] (GDPR) that will come into effect in 2018. The amount of compliance measures to be taken depends on the firms' exposure to and involvement in the processing of personal data. Even if no major overhaul is required, it is recommended that firms begin a data privacy assessment now, implement the necessary measures and monitor their activities on a continuous basis thereafter. Most likely, all PE firms operating in the EU will be subject to the GDPR one way or another. The companies should prevent various investment, legal, reputational or operational risks related to the processing of personal data from materialising.

What is the GDPR?

The GDPR is the new EU legal framework for the protection of natural persons with regard to the processing and free movement of their personal data. It aims to harmonise the application of rules throughout the European Union and to create a consistent and homogenous framework in relation to the processing of personal data. It sets out the data subjects' rights, the data controllers' and data processors' obligations, as well as the national supervisory authorities' enforcement powers and the applicable sanctions in case of infringement.

The Regulation will be directly applicable in the 28 EU Member States on 25 May 2018 and it will lead to the repeal of some of the national legislation currently in force. It will also be supplemented by guidelines from the European Data Protection Board on more practical aspects, therefore regular monitoring of changes and evolutions to the current situation will be required.

[1] Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and the free movement of such data.

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How are PE houses affected by the GDPR?

PE houses "process personal data", from a variety of sources: employees, directors, limited partners, customers and staff from portfolio companies, investment targets, counterparties, vendors or service providers. If personal data is found in the PE ecosystem (HR, IT, data analysis systems, customer data bases, data rooms, etc.) and needs to be processed somehow, the Regulation applies.

Moreover, firms must prevent risks related to the processing of personal data from materialising. An investment risk could arise if a portfolio company violates data privacy and data security regulations and is sanctioned. A sanction could result in a decrease in the return of the fund's capital investment. There are also legal risks arising from compensation claims from individuals and from inspections by supervisory authorities, leading sometimes to law enforcement action against personal data breaches. Firms must also avoid any reputational risk likely to be caused if personal information entrusted to them is handled unlawfully, by illegally profiling investors or due to misuse by an employee or contractor, for instance. Finally, implementing and running an effective and cost-efficient data privacy and security system across the PE house group, the managed funds and the portfolio companies, may pose an operational risk if the measures taken are neither appropriate nor effective.

Under which circumstances does the GDPR apply?

The GDPR guarantees rights for individuals only, regardless of their nationality or residence. The Regulation applies to data controllers or processors (legal entities or individuals alike) if they carry on activities in the European Union or outside the EU, in some cases. For instance, if investment services are offered from Singapore to natural persons in the EU, even if no payment is requested, or when a Canadian firm monitors the behaviour of its European client manifest in the EU, the Regulation will apply.
The Regulation applies to almost every operation performed on personal data. For instance, the Regulation would apply when employees' personal details are collected and recorded in the company's HR files, when data on the portfolio companies' staff is structured and disclosed to private insurance companies or to trustees of employees' incentive plans. Similarly, storing, erasing or destroying limited partners' details with respect to their investments may trigger the application of the Regulation. Also, organising and disclosing personal data originating from portfolio companies in view of their sale or accessing and using personal data from target investment data rooms may lead to a PE firm being subject to the GDPR.

Relevant "personal data" refers to any information that has the potential to identify a given natural person (such as name, identification number, location data, online identifier or physical, genetic, economic or social identity features). The more sensitive the personal data, (e.g. genetic or biometric data, health, trade union membership or political opinions), the more stringent the conditions for its processing and therefore, the more burdensome the implementation measures become.

What are the main GDPR requirements for PE firms?

Whether it is acting as controller or processor, a PE firm is required to process personal data according to the principles set out in the Regulation. It must ensure a lawful, fair and transparent processing of personal data and guarantee its integrity and confidentiality. It shall minimise the data collected to what is necessary and limit its processing to the purpose for which it was collected. It must also keep the data up to date and store it only for as long as necessary. Finally, if the firm is deemed to be a controller, i.e. if it determines the purposes and means of processing of personal data (this will be the case for the investment managers), it must also be able to demonstrate compliance with all the above principles.
PE firms must also be aware of the newly created rights individuals have with respect to their personal data. Not only is a business subject to an enhanced information obligation as to the purposes and legal basis for processing, but it must also respect the individual's rights to access, rectify or erase the data, restrict the processing, object to direct marketing, profiling or automated decision-making, or require data portability. Practical implementation of processes and procedures is required in order to handle such requests and complaints as well as additional staff training, where appropriate.

Investment managers delegating fund administration services to third parties need to make sure that the outsourcing contract contains the necessary data security safeguards and that the processor cooperates appropriately with the EU supervisory authority in case of data breaches.

The legal framework for any transfer of personal data outside the European Union is restrictive for the time being, as there are only a limited number of scenarios where such transfers are allowed and meeting some of the conditions triggers a costly and time-consuming process. For instance, transfers to Jersey are allowed without prior authorisation because it is supposed that an adequate level of protection is ensured, whereas transfers to India may require the concerned individual's express consent or that the transfer be made based on binding corporate rules (BCRs).

Even if it is no longer necessary to require prior authorisation for processing the personal data, the PE firms should foster a good relationship with the relevant national or lead supervisory authority, especially in the light of the new investigative and corrective powers the latter have acquired.

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Any data breaches (loss, theft or destruction of data) must be recorded and remedial actions justified and documented in detail and communicated to the supervisory authority and, under some circumstances, to the affected individuals. In certain cases, a data protection officer (DPO), firm- or group-wide, must be appointed, in order to implement and monitor the personal data processing activities. The sanctions for violating the Regulation can amount to as much as 4% of the annual worldwide turnover or €20mio, whichever is greater.

How can PE firms become GDPR compliant?

There is no one size fits all solution for compliance with the GDPR. Each PE firm must perform a gap analysis of its current personal data processing practices and take all appropriate measures to comply with the Regulation. In addition to completing its own audit, the PE firms should also consider whether the funds they manage and their portfolio companies' practices are in line with the new rules.

The first step is to identify all types of data processed, the legal basis for the processing (whether it is the data subject's consent or the performance of a contract, for example), the data lifecycle management (from collection to deletion), the use of third party processors, any data flows within and outside the European Union, the technology systems used, the security measures applied and the applicable contracts and policies.

Next, depending on the presence of any particular requirements of the Regulation (such as "high risk" processing or processing of sensitive data), and focusing on the privacy by design/ by default requirements, the firms should upgrade their procedures to take into account the data subject's enhanced rights, amend or prepare appropriate privacy notices, contracts with processors and internal policies, adopt appropriate safeguards (pseudonymisation or anonymisation), appoint a DPO and train staff. The firms could take one step further by incorporating BCRs, approved codes of conduct or certifications into their organisation.

Finally, regular reviews of the processing activities, updates to the relevant documents and monitoring of the relevant legislation and guidance from regulators will be required[2]. Even if the Regulation is meant to provide a harmonised framework across the EU for the processing of personal data, the Member States retain flexibility in certain cases (e.g. making the appointment of the DPO mandatory in all cases or requiring notification of the use of model contracts to the national supervisory authority).

GDPR-compliant personal data handling should be embedded in all activities of a PE firm, from staff recruitment, retention and training, through developing and offering new services and products and forging a trustworthy customer relationship, to inclusion in the sale/acquisition and due diligence process on any target. The shift in paradigm from an ex-ante authorisation to an ex-post control should be a warning to data controllers/processors that the supervisory authorities are likely to focus their efforts on enforcement measures and sanctions from now on.

We can help you navigate this complex piece of legislation by delivering tailored guidance on its implementation, preparing the appropriate documentation, conducting suitable staff training and assisting you in the product/service design phase and implementation of compliance measures.

For more information, please contact Jérémie Schaeffer at jeremie.schaeffer@ atoz.lu or Suzana Guzu Mercea at suzana. guzu@atoz.lu.

[2] In Luxembourg, the recent draft law n° 7184 introduces on one hand stringent safeguards and limitations for the processing of special categories of personal data or health-related data, as well as for the processing of personal data for research purposes. On the other hand, it allows derogation from some prohibitions in the Regulation, when the processing is made for journalistic expression, in order to safeguard the freedom of expression. It also extends the powers of the National Commission for Data Protection and repeals the Law of 2 August 2002 on the protection of individuals with regard to the processing of personal data. The law will apply to all Luxembourg-based data controllers/processors and it is irrelevant of the source of the data.

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THE OECD RELEASES THE 2017 REVISION OF ITS TRANSFER PRICING GUIDELINES

OUR INSIGHTS AT A GLANCE

- In July, the OECD released the 2017 Revision of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration with several chapters of the OECD Guidelines significantly amended as a result of the OECD's work on the BEPS Project
- The revision gives new guidance in regards to the following aspects of the arm's length principle: accurate delineation of a transaction, examination of risk within the functional analysis and non-recognition of an accurately delineated transaction by the tax administration
- Transfer pricing documentation requirements, arm's length conditions for the use or transfer of intangibles, a charge mechanism for cost determination in cases of low value-adding intra-group services and guidelines on application of the arm's length principle in the case of business restructuring have also been added or amended in the revision
- MNEs and international investors should review their current transfer pricing practices against the backdrop of revised version of the OECD Guidelines with a view to detect potential pressure areas and to ensure compliance with documentation requirements

On 11 July 2017, the OECD released the 2017 Revision of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines"). Several chapters of the OECD Guidelines have been significantly amended as a result of the OECD's work on the Base Erosion and Profit Shifting ("BEPS") Project. This article provides a clear and concise overview of the most important changes of the OECD Guidelines.

Introduction

The OECD Transfer Pricing Guidelines reflect the consensus of OECD member countries towards the application of the arm's length principle as provided in Article 9 (1) of the OECD Model Tax Convention. The arm's length principle is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations.

The arm's length principle requires that, for tax purposes, the terms and conditions agreed to between related parties in their commercial or financial relations should correspond to those that one would have expected in transactions between unrelated parties. When the terms and conditions agreed upon in controlled transactions differ from the arm's length standard, tax administrations may, for tax purposes, perform transfer pricing adjustments.

When the OECD launched the BEPS Project in 2013, the OECD considered transfer pricing as one of the key pressure areas in international taxation. Notably, 4 of the 15 Actions of the BEPS Action Plan focused on transfer pricing and related documentation requirements:

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- Action 8 focusing on intangibles,
- Action 9 focusing on risk and capital,
- Action 10 focusing on other high risk transactions, and
- Action 13 focusing on transfer pricing documentation.

The ultimate purpose of the work of the OECD was to ensure that transfer pricing outcomes are in line with "value creation". The 2017 Revision of the OECD Guidelines reflects the wording provided in the Final Report to Actions 8 – 10 (Aligning Transfer Pricing Outcome with Value Creation) and the Final Report on Action 13 (Transfer Pricing Documentation) released in October 2015.

Arm's length principle (Chapter I)

Contractual terms vs. actual conduct

As a rule, the accurate delineation of the actual transaction is based on an analysis of the written contracts and the actual conduct of the parties. When there is a discrepancy between the written contracts and the actual conduct of the parties, the actual transaction should be delineated in accordance with the conduct of the parties.

While this principle was already applicable under the previous version of the OECD Guidelines, the new guidance states several times that contractual provisions may not be relied on to identify ("delineate") the transaction or define the functions, assets and risks assumed by the related parties involved in a transaction.

This seems to suggest that taxpayers and tax authorities should scrutinise every nuance of the intercompany relationship. The proposed guidance may likely be used by some tax authorities (i) to frustrate even ordinary, routine transfer pricing exercises, (ii) to induce a more extensive use of profit splits and (iii) to expand the circumstances in which the transactions may be disregarded or re-characterised.

Identifying risks in controlled transactions

The guidance provided in Chapter I, Section D ("Guidance for applying the arm's length principle") of the OECD Guidelines has been significantly extended and amended as a result of the work performed by the OECD under Action 9 of the BEPS Project. The objective of Action 9 was to tackle contractual risk allocations that lack commercial rationality of uncontrolled transactions. In this regard, new guidance included in the OECD Guidelines requires that transactions be appropriately delineated so that the transfer pricing outcome is consistent with each entity's contribution to value creation. However, while the aim sounds plausible, the new guidance creates severe uncertainty and seems in parts even to deviate from the arm's length principle.

The OECD Guidelines emphasise the importance of the examination of risks within the functional analysis. The assumption of risks significantly influences the prices and other conditions between the associated enterprises. However, practical experience shows that analysing risk in relation to controlled transactions is more intricate than analysing functions and assets.

Typically, in the open market, the assumption of increased risk should also be compensated for by an increase in the expected or anticipated return, although the actual return may or may not increase depending on the degree to which the risks are realised. Hence, tax authorities cannot expect a taxpayer that assumes a higher risk to earn higher returns in a scenario in which the risk has materialised and negatively affected the income situation of the taxpayer.

The 2017 Revision of the OECD Guidelines provides significant guidance on the examination of risk within the functional analysis. However, it is explicitly stated that the detailed guidance in relation to the analysis of risks as part of the functional analysis (covering functions, assets and risks) should not be interpreted as indicating that risks are more important than functions or assets. Instead, the detailed guidance on risks is an indication for the practical difficulties presented by risks.

Non-Recognition of the accurately delineated transaction

While the accurately delineated transaction should generally be considered for transfer pricing purposes, the OECD Guidelines provides guidance as to when a tax administration may, in exceptional circumstances, disregard the accurately delineated transaction.

The OECD is conscious of the high likelihood of double taxation in case of non-recognition and the adverse consequences for international trade and business that go with it. Therefore, the OECD Guidelines emphasise that the actual transaction should be recognised and must not be substituted by other transactions in the transfer pricing analysis unless exceptional circumstances apply.

Tax administrations should use every effort to determine pricing for the actual transaction as accurately delineated under the arm's length principle. In this regard, it is explicitly stated that non-recognition should not be used simply because determining the arm's length price is difficult.

Evidently, non-recognition will not apply in case of transactions that can also be found between independent parties. Nevertheless, MNEs have the ability to enter, for sound business reasons, into a variety of transactions that cannot or hardly be found between independent parties. In this regard, the OECD Guidelines explicitly state that the mere fact that a controlled

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transaction may not be seen between independent parties does not as such mean that it should not be recognised.

Non-recognition and replacement of a controlled transaction by an alternative transaction should only be considered by tax administrations when the transaction overall differs from what might be expected from independent enterprises behaving in a commercially rational manner. Hence, it needs to be established by the tax administration that the actual transaction prevents the determination of a price that would be acceptable to both parties to the controlled transaction, taking into account their respective perspectives and the options realistically available to each party at the time they enter into the controlled transaction.

In light of the above, the key question is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between third parties under comparable circumstances. In contrast, whether or not a controlled transaction can be found between unrelated parties is wholly irrelevant in this respect.

In case a controlled transaction is not recognised in accordance with OECD guidance, tax administrations should replace the actual transaction by a transaction that is as much as possible consistent with the facts and circumstances of the actual transaction while achieving a commercially rational expected result.

Transfer pricing documentation (Chapter V)

Chapter V of the OECD Guidelines contains a revised standard for transfer pricing documentation which has been developed under the work on Action 13. According to the new guidance, multinational enterprises (MNEs) are requested to prepare a "master file" regarding their global business operations and a "local file" in each country.

In addition, a template for country-by-country reporting (CbCR) is contained in the Annex to draft Chapter V. The new template requires MNEs to report their income, earnings, taxes paid and accrued as well as certain measures of economic activity (for example, employment, capital and tangible assets in each tax jurisdiction) to the tax administrations of the countries where they operate. It has been agreed to review the adequacy of the scope of the information required no later than the end of 2020.

While it has been expressly stated that the compliance burden and costs to businesses should be limited, it will be extremely burdensome and costly to implement the new transfer documentation on a global basis. Moreover, although the declared purpose of the country-by-country reporting is to provide tax administrations with a risk management tool to better understand, control and tackle perceived BEPS behaviours, businesses may fear that tax administrations will use the information in order to selectively apply some kind of formulary apportionment where it appears to be more beneficial from a tax revenue perspective.

The simultaneous application of the arm's length principle and the formulary apportionment method would likely entail double taxation and long-lasting disputes with the tax administrations involved. Last but not least, there is a risk relating to data protection and confidentiality when multinationals provide detailed and commercially sensitive information relating to their operations.

Intangibles (Chapter VI)

Chapter VI of the OECD Guidelines provides guidance on the determination of arm's length conditions for transactions involving the use or transfer of intangibles. Chapter VI has been completely rewritten as part of the OECD's work on Action 8 and requires members of an MNE group to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation ("DEMPE" functions) of intangibles.

The guidance contained in this Chapter is intended to ensure that:

- Legal ownership of intangibles alone does not determine entitlement to returns from the exploitation of intangibles;
- Associated enterprises performing important value-creating functions related to DEMPE functions can expect appropriate remuneration;
- An associated enterprise assuming risk in relation to DEMPE functions must exercise control over the risks and have the financial capacity to assume the risks;
- An associated enterprise providing funding and assuming the related financial risks, but not performing any functions relating to the intangible, could generally only expect a risk-adjusted return on its funding;
- If the associated enterprise providing funding does not exercise control over the financial risks associated with the funding, then it is entitled to no more than a risk-free return;
- The pricing of hard-to-value intangibles upon a transfer between associated enterprises has to be carefully analysed.

Overall, the new guidance seems to give tax administrations a lot of tools to challenge controlled transactions involving intangibles, resulting in massive legal uncertainty. Going forward MNE groups have to more than ever take care of how they develop and manage IP assets, giving attention to substance, operational management and commercial rationale.

Intra-group services (Chapter VII)

The new Chapter VII of the OECD Guidelines provides additional guidance on a particular category of intra-group services referred to as "low value-adding services" and proposes a simplified approach for the determination of arm's length charges, including a simplified benefits test.

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Low value-adding intra-group services are particularly performed by a member of a group on behalf of one or more other group members where such services:

- are of a supportive nature;
- are not part of the core business of the group;
- do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
- do not involve the assumption or control of substantial or significant risk and do not give rise to the creation of significant risk.

According to the OECD guidance, a simplified charge mechanism can be applied in case of low value-adding services. The basic benefits of using the simplified approach are:

- A reduction of the compliance effort of meeting the benefits test and in demonstrating arm's length charges;
- Providing greater certainty for MNE groups that the price charged for the qualifying activities will be accepted by the tax administrations that have adopted the simplified approach when the conditions of the simplified approach mentioned in paragraph 7.45 of the new Chapter VII have been met; and
- Providing tax administrations with targeted documentation enabling efficient review of compliance risks.

The simplified charge method for low value-adding intra-group service costs is to allocate among members of the group the costs in the cost pool that benefit multiple members of the group. The taxpayer will select one or more allocation keys to apply for this purpose which are appropriate for the nature of the services.

According to Section 7.61 of the OECD Guidelines (as amended), service providers should generally apply a profit mark-up of 5% on their costs in relation to the rendering of low value-added services. Notably, this profit mark-up of 5% does not need to be justified by a benchmarking study.

Business restructuring (Chapter XI)

Chapter XI of the OECD Guidelines deals with the application of the arm's length principle in case of business restructuring. The guidance on non-recognition in case of business restructuring provided in Chapter XI of the OECD Guidelines has also been updated in the revised version of the OECD Guidelines in order to be consistent with the guidance provided in Chapter I (Arm's length principle). Accordingly, the commercial rationality of a transaction should be established considering the options realistically available to the parties at the moment they enter into a controlled transaction or business restructuring.

Conclusion

The 2017 Revision of the OECD Guidelines follows the Final Reports on Actions 8 – 10 and 13 of the OECD BEPS Project, amending, extending and replacing previous guidance on the application of the arm's length principle. Unfortunately, some of the new guidance introduces additional room for subjectivity and challenges by tax administrations (options realistically available, reallocation of risks, non-recognition of the accurately delineated transaction, etc.) which creates additional uncertainty for taxpayers and may lead to increased controversy between taxpayers and tax administrations. Likewise, the CbCR, which does not as such jeopardise the arm's length principle, may motivate tax administrations to tax multinational enterprises selectively with some kind of formulary apportionment. This problem will likely be exacerbated by the increased emphasis on the profit split method in the post-BEPS environment.

Luxembourg anticipated the update of the OECD Guidelines and implemented as early as 1 January 2017 a new Article 56bis of the Luxembourg Income Tax Law that complements Article 56 (arm's length principle) and replicates some of the guidance provided in Chapter I of the OECD Guidelines. Moreover, on 27 December 2016 the Luxembourg tax authorities released a new Circular on the tax treatment of finance companies, setting out a transfer pricing regime that is consistent with the 2017 Revision of the OECD Guidelines. All this cements the increasing importance of transfer pricing and related documentation for Luxembourg tax and risk management purposes.

Ultimately, MNEs and international investors should review their transfer pricing against the backdrop of revised version of the OECD Guidelines with a view to detect potential pressure areas and to ensure compliance with documentation requirements. In the current international tax environment of heightened transparency and scrutiny, companies would be wise to integrate the documentation of transfer prices in their wider tax strategy, using it as a means to reflect the business rationale behind their corporate structure and intra-group transactions.

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TAX TREATY BENEFITS FOR PRIVATE EQUITY FUNDS: WHAT'S NEW?

OUR INSIGHTS AT A GLANCE

- In July, the OECD Committee on Fiscal Affairs released the (not yet approved) draft contents of the 2017 update to the OECD Model Tax Convention prepared by the Committee's Working Party. The update deals with conclusions reached in the various BEPS reports, including the report on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances)
- The Action 6 report makes a distinction between CIVs and non-CIV. In view of the definition provided, it appears that most private equity funds will not qualify as a CIV but, instead, as a non-CIV
- In January 2017, the OECD released for public comment an additional discussion draft including three draft examples addressing the application of Action's general abuse rule the Principal Purpose Test (PPT) to non-CIVs (it appears that most private equity funds will not qualify as a CIV but, instead, as non-CIVs)
- The final version of these three examples is included in the draft contents of the 2017 update to the OECD Model Tax Convention with a statement according to which the examples should be considered as purely illustrative and should not be interpreted as providing conditions or requirements that similar transactions must meet in order to avoid the application of the PPT

On 11 July 2017, the OECD Committee on Fiscal Affairs released the draft contents of the 2017 update to the OECD Model Tax Convention prepared by the Committee's Working Party. The update is a draft in the sense that it has not yet been approved by the Committee on Fiscal Affairs or by the OECD Council. The update includes the numerous conclusions reached in the various BEPS reports released in October 2015.

One of these conclusions deals with issues of treaty abuse (Action 6 of the BEPS Action Plan) and one of the ways to fight against treaty abuse according to the OECD being to insert an anti-abuse rule called Principle Purpose Test (PPT) into tax treaties. Action 6 of the BEPS Action Plan report (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) targets companies which use conduit companies to artificially shift income. While the primary targets are multinational corporations, private equity firms raising money across multiple jurisdictions and investing across multiple jurisdictions via different types of investment vehicles will come under scrutiny.

The PPT is a general anti-abuse rule to be included in double tax treaties and which is based on the principal purpose of transactions or arrangements. The PPT is included in the BEPS Action 6 report and is part of the OECD Multilateral Instrument (MLI). When signing the MLI in June 2017, Luxembourg decided to subject all its tax treaties in force to the PPT (to the extent concluded with jurisdictions also parties to the MLI). This is why the PPT and its practical application are of utmost importance.

The Action 6 report makes a distinction between CIVs and non-CIVs: a CIV is a fund that is widely-held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established. In the view of this definition, it appears that most private equity funds will not qualify as a CIV but, instead, as a non-CIV.

The final version of the BEPS Action 6 report indicates that the OECD will continue to examine issues related to the treaty entitlement of non-CIV funds in order to ensure that the new treaty provisions included in the BEPS Action 6 Report (including the PPT) adequately address the treaty entitlement of these funds.

In March 2016, the OECD released a discussion draft as part of the follow-up work on this issue. It included a number of specific questions related to concerns, identified in comments

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received on previous discussion drafts related to the BEPS Action 6 Report, as to how the new provisions included in the BEPS Action 6 Report could affect the treaty entitlement of non-CIVs as well as possible ways of addressing the concerns that were suggested in these comments or subsequently.

In January 2017, the OECD released for public comment an additional discussion draft including three draft examples addressing the application of the PPT to non-CIVs. The aim of the discussion draft was to elicit feedback from any interested party on three examples that would be added to the OECD commentaries and would illustrate situations in which a non-CIV fund should be considered as not raising treaty-shopping concerns and should thus be granted treaty benefits. The draft contents of the 2017 update to the Model OECD Tax Convention now include the final versions of these three examples.

Review of non-CIV examples

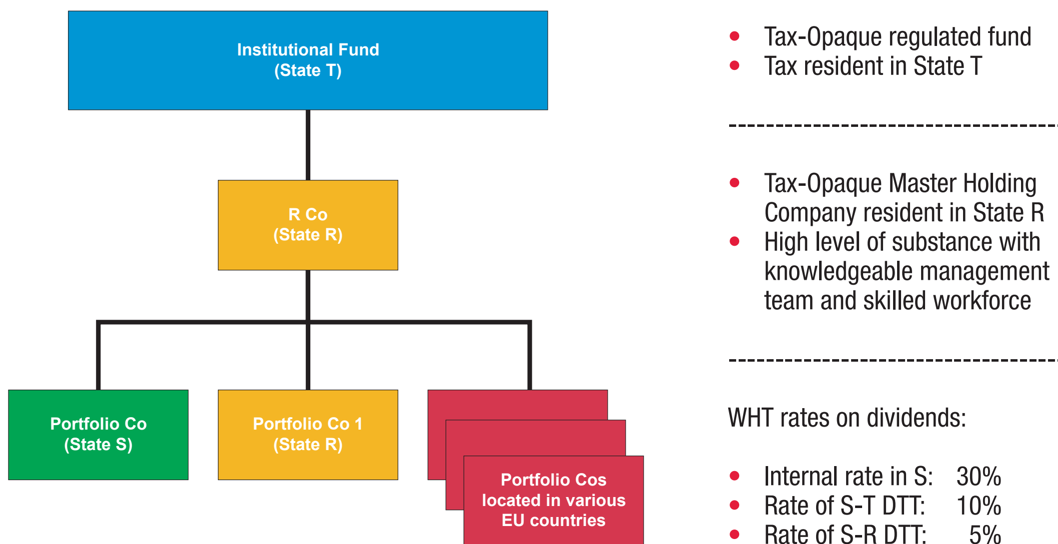
The three examples address the application of the PPT to regional investment platforms, securitisation companies, and funds that invest in immovable property. Both the regional investment platform example and the real estate fund examples are relevant for private equity funds.

On behalf of Taxand, we commented these examples and recommended that a statement be made in order to clarify that these three examples do not mean that "real life" facts that do not fit within the narrow confines of those outlined in the examples will not satisfy the PPT rule.

Our comments seem to have been taken into account by the OECD as the following statement was added: "When reading these examples, it is important to remember that the application of paragraph 9 must be determined on the basis of the facts and circumstances of each case. The examples below are therefore purely illustrative and should not be interpreted as providing conditions or requirements that similar transactions must meet in order to avoid the application of the provisions of paragraph 9."

This is good news and means that some flexibility is allowed when comparing a specific situation to one of the three examples. In addition, it means that not only situations falling within the scope of these examples will be "safe" from a PPT perspective. Therefore, additional situations and structures may also be considered as not giving rise to treaty shopping concerns.

Example 1: Regional investment platform



- In making its decision whether or not to invest in Portfolio Co, R Co considers the existence of a benefit under the State R-State S DTT (WHT rate of 5% vs. WHT rate of 10%). This alone would not be sufficient to trigger the application of the PPT.
- The intent of tax treaties is to provide benefits to encourage cross-border investment.
- It is necessary to consider the context in which the investment was made, including for establishing R Co in State R and the investment functions and other activities carried out in State R.
- In the absence of other facts or circumstances showing that R Co's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCO.

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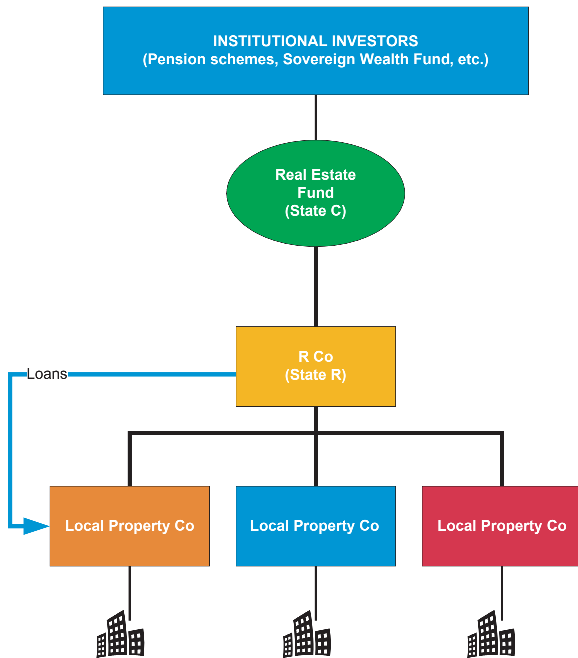
Example 2: real estate fund example



- Tax transparent partnership in State C
- Managed by a regulated Fund manager

- Holding Company resident in State R
- Manages the real estate assets of Real Estate Fund
- Provides debt/equity financing to local property companies

Treaty benefits

- R Co does not obtain treaty benefits that are better than the benefits to which its investors would have been entitled if they had made the same investments directly.

- R Co is established for a number of commercial and legal reasons, including protecting Real Estate Fund from the liabilities of and potential claims against the fund's real estate assets, to facilitate debt financing and the making, management and disposal of investments and administering the claims for relief of withholding tax under any applicable DTT as it is administratively simpler for one company to obtain treaty relief.
- Real Estate Fund decided to establish R Co in State R because of the political stability of State R, its regulatory and legal systems, lender and investor familiarity, access to appropriately qualified personnel and the extensive tax convention network of State R, including its treaties with other States within the specific geographic area targeted for investment.
- R Co does not derive any treaty benefits that are better than those to which its investors would be entitled.
- In the absence of other facts or circumstances showing that R Co's investments are part of an arrangement, or related to another transaction, undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the tax treaties between R Co and the States in which R Co's immovable property investments are located.

When we commented the real estate fund example of the January 2017 discussion draft, we indicated that it might be too restrictive or might not be fully in line with the current reality of non-CIVs. In the draft update, the real estate example has been amended so as to reflect the common practice of real estate funds being typically structured over a central holding company holding the shares in local property companies. It is this particular fact pattern that needs to be accepted under the PPT test in order to benefit from treaty benefits between the source state and the state of the holding company. This is very good news and shows that the OECD is open to adopting positions which are in line with real life circumstances. This should also mean that the scope of the example is wider and that the same conclusions should be reached in the case of other assets classes (i.e. assets other than real estate assets).

Next steps

The 2017 update to the OECD Model Tax Convention prepared by the Committee's Working Party will be submitted for the approval of the Committee on Fiscal Affairs and of the OECD Council later in the course of 2017. This means that, as of today, the draft does not necessarily reflect the final views of the OECD and its member countries. Therefore, it will be necessary to await the release of the final version of the 2017 update in order to have a clear view on the position of non-CIVs as regards treaty benefits.

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