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Luxembourg's Amended Definition of a Permanent Establishment: Is It Really Something New?

by Oliver R. Hoor

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In this article, the author examines Luxembourg's recently amended definition of a permanent establishment and considers whether it really represents a change in the tax law.

Luxembourg's 2019 tax reform implements the EU anti-tax-avoidance directive (Council Directive (EU) 2016/1164, ATAD) and other base erosion and profit-shifting-related measures into domestic tax law, including an amendment of the permanent establishment definition. The new provision concerns the interpretation of the PE concept when Luxembourg taxpayers have a PE in a treaty country. On February 22 the Luxembourg tax authorities released a circular (Circular L.G. No. 19) that provides further guidance on this topic. This article provides an overview of the PE concept in tax treaties and under Luxembourg tax law, analyzes the content of the circular, and considers the practical implications of the amended PE definition.

I. Introduction

The PE concept plays a prominent role in the tax treatment of cross-border business activities, and it is relevant for the application of both domestic tax law and tax treaties. However, the primary purpose of the PE concept is different for the different bodies of law.

Under Luxembourg tax law, the PE definition is most useful for defining when a nonresident enterprise is subject to corporate income tax and municipal business tax on profits it realizes through a Luxembourg PE, according to article 156(1), No. 1 of the Luxembourg Income Tax Law (Impôt sur le Revenu, or LITL). In contrast, the concept's main role in tax treaties — such as article 5 of the OECD model tax convention,[1] which provides a definition of PE that Luxembourg frequently includes in its tax treaties — is to determine the right of a contracting state to tax the profits of an enterprise that is resident in the other contracting state. This is because, according to article 7 of the OECD model, a contracting state cannot tax business profits of enterprises resident in the other contracting state unless the enterprise carries on business through a PE located therein.[2]

In that case, article 7 of the OECD model allocates an unlimited primary taxing right to the PE's host state. The enterprise's residence state must therefore adopt a method for eliminating double taxation. When Luxembourg taxpayers have a PE in a contracting state, Luxembourg frequently adopts the exemption method and exempts profits that are attributable to a foreign PE.

[1]Unless otherwise specified, references to the OECD model and its commentary are to the 2017 version.

[2]*See* Oliver R. Hoor, *The OECD Model Tax Convention — A Comprehensive Technical Analysis* 103 (2015).

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II. Definition of PEs Under Tax Treaty Law

A. Broad Overview of PEs

The definition of the term "permanent establishment" for tax treaty purposes is provided in article 5 of the OECD model, which supplements and completes article 7 of the OECD model. Notably, the unlimited primary taxing right of the host state is conditioned upon the existence of a PE within the meaning of that definition.

Moreover, when dividends, interest, and royalties are paid to an enterprise resident in the other contracting state, articles 10(4), 11(5), and 12(3) of the OECD model restrict the taxing rights of the source state only when the income is not attributable to a PE located in the source state. The concept is also relevant in determining which contracting state may tax some capital gains under article 13 of the OECD model and some "other income" under article 21 of the OECD model.

From a legal perspective, a PE is not an independent enterprise: It is a legally dependent part of an enterprise with a head office in another state (and, possibly, additional PEs in other states). While there cannot be any legally binding contractual relationships between the head office and a PE — or between different PEs of the same enterprise — tax law deems PEs to be partially independent from the other parts of the enterprise. This allows for the attribution of profits based on the activities carried out through the PE, including internal dealings with its head office and other PEs of the same enterprise.[3]

There are two types of PEs contemplated by article 5 of the OECD model. The first, which the OECD model discusses in articles 5(1) through (4), is an establishment that is part of the same enterprise and under common ownership and control such as a place of management, an office, and so forth. The second type is an agent that is legally separate from the enterprise, but nevertheless dependent on the enterprise to the point of forming a PE — that is, the so-called dependent agent PE, covered by articles 5(5) and (6).

The OECD model's definition of a PE received a lot of attention during the BEPS project. The OECD dedicated the action 7 report to developing a PE definition that would prevent the artificial avoidance of PE status[4] and reduce the threshold for PE status.

B. Essential Characteristics of PEs

Article 5(1) of the OECD model defines a PE as a "fixed place of business through which the business of an enterprise is wholly or partly carried on." Hence, the definition contains the following conditions for PE status:

- the existence of a place of business — such as a business premises or, in some instances, machinery or equipment;
- this place of business must be fixed — that is, it must be established at a distinct place with a degree of permanence; and
- the enterprise carries on its business through this fixed place.

1. Place of Business

As paragraph 10 of the commentary on article 5 of the OECD model explains, the term "place of business" has a broad definition that covers any premises, facilities, or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A qualifying place may include substantial machinery and equipment, such as computer hardware. Notably, a place of business does not require the presence of human beings. Paragraph 10 of the commentary on article 5 of the OECD model further notes that the premises may be owned, rented, or otherwise at the disposal of the enterprise, and may even be situated in the business facilities of another enterprise.[5]

No formal legal right to use a place is required, as article 5, paragraph 11 of the

[3] *See* Hoor, "The Tax Treatment of Permanent Establishments," 54(7) *Eur. Tax'n* 287 (July 2014).

[4] *See* Hoor and Keith O'Donnell, "BEPS Action 7: The Attempt to Artificially Create a Taxable Nexus," *Tax Notes Int'l*, June 8, 2015, p. 929.

[5] *See* Jacques Sasseville and Arvid Skaar, "Is There a Permanent Establishment? — General Report," 94a *Cahiers de Droit Fiscal International* 17 (2009); and Hoor, *supra* note 2, at 104.

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commentary explains.[6] Rather, the term "disposal" requires mere factual use, regardless of whether the authorization is explicit — a formal right to use attributed by law, contract, or other lawful formalized consent — or implicit — a factual right to use based on implicit authorization or tolerance. Nevertheless, paragraph 12 of the commentary on article 5 of the OECD model clarifies that the mere presence of an enterprise at a particular location — meaning sporadic or infrequent presence — does not necessarily mean that the location is at the disposal of the enterprise. This evaluation should focus on the particular kind of business under scrutiny. For example, a salesman who regularly visits his main customers to take their orders does not have a place of business at their premises. Material presence will be met when the use of the place is so extensive that it goes beyond mere presence. Mere presence is, therefore, the threshold — once the presence surpasses this threshold, the location qualifies as being at the enterprise's disposal.

2. Fixed

To qualify as a PE, the place of business must be fixed. It follows that the place of business must be linked to a geographical point. A physical space or an object that serves the foreign taxpayer's business activity will suffice.[7] Equipment can be a fixed place of business if, as paragraph 21 of the commentary on article 5 of the OECD model explains, it remains at a particular site. The nexus to the earth does not have to be visible from the surface of the earth — underground pipelines, railroads, mines, and so forth meet the requirements of the fixed location test for a PE.

Since a PE generally only exists if the place of business has some degree of permanency, a temporary place of business should not constitute a PE. In principle, the duration test is applied retrospectively. If the enterprise originally intended a business to last for a short period of time but it actually lasts for a longer period, it may meet the duration test. In this case, the taxpayer's intentions are less important than the factual duration of the right of use. However, if the taxpayer intended the right of use to the place of business to last for a long or indefinite time but the use was terminated after only a short period of time, a PE still exists. In that case, the intention is more important than the factual duration of the right of use.

Notably, interruptions of the activities do not cause a PE to cease to exist as long as the operations are carried out regularly. Paragraphs 28 and 29 of the commentary on article 5 in the OECD model establish that in case of recurrent activities, the periods of time during which the place is used need to be considered in combination.

3. Carrying On Business

The third requirement is that the enterprise must carry on business through the fixed place in the host country. As paragraph 6 of the commentary on article 5 of the OECD model states:

> This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

The activity does not need to be of a productive character.[8]

Generally, most of the business of an enterprise is carried on by an entrepreneur or personnel, including employees and others who receive instructions from the enterprise like dependent agents. Notably, according to paragraph 39 of the commentary on article 5, the degree of power that the personnel have in relations with third parties is irrelevant. Further, as paragraph 41 of the commentary on article 5 explains, when automated equipment constitutes a PE, the activities of the actual personnel may be limited to setting up, operating, controlling, and maintaining the equipment.

[6] *See* Hoor, "Comments on the OECD Discussion Draft on the Meaning of 'Permanent Establishment,'" *Tax Notes Int'l*, Jan. 16, 2012, p. 207.

[7] *See* Sasseville and Skaar, *supra* note 5, at 25; and Jürgen Lüdicke, "Recent Commentary Changes Concerning the Definition of Permanent Establishment," 58(5) *Bulletin for International Taxation* 191 (May 2004).

[8] Sasseville and Skaar, *supra* note 5; Hoor, *Etablissements Stables – Concept et Traitement Fiscal Selon le Droit Fiscal Interne et les Conventions Fiscales en Vigueur* 20 (2015); and Hoor, "The Concept of Permanent Establishments," 54(4) *Eur. Tax'n* 119 (Apr. 2014).

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Paragraph 44 of the commentary on article 5 of the OECD model addresses some fundamental details regarding timing. A PE begins to exist as soon as the enterprise begins to carry on its business through a fixed place of business. The PE ceases to exist upon the disposal of the fixed place of business or the termination of any business activity through the former PE. A temporary interruption of operations does not constitute a closure.

Article 5(2) of the OECD model lists several examples of fixed places of business that constitute a PE, including places of management, branches, offices, factories, and so forth. This list is illustrative and nonexclusive.[9] However, paragraph 45 of the commentary on article 5 of the OECD model convention clarifies that even the listed examples only constitute PEs if they meet the requirements of article 5(1) of the OECD model.[10] Further, since the list is illustrative, specific tax treaties often include other examples that are likely to be relevant to the countries in question, such as farms or plantations.

C. Building Sites, Construction, and Installation

According to article 5(3) of the OECD model:

> A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

Paragraph 50 of the commentary on article 5 of the OECD model convention explains that the term "building site or construction or installation project" includes many items such as:

- construction of buildings;
- construction of roads, bridges, or canals;
- renovation — that is, extraordinary work, beyond mere maintenance or redecoration, intended to extend the economic life of a good or significantly increase its productivity — of buildings, roads, bridges, or canals;[11]
- the laying of pipelines (and excavating or dredging); and
- the installation of equipment (for example, a complex machine or other substantial equipment).[12]

Under this section, a PE is deemed to exist once the 12-month period is exceeded even if the general conditions laid down in article 5(1) of the OECD model are not met. In these circumstances, paragraph 54 of the commentary on article 5 of the OECD model dictates that the site or project constitutes a PE from the first day of activity.

D. Preparatory and Auxiliary Activities

Article 5(4) of the OECD model contains exceptions to the general rule found in article 5(1). It lists some activities of a preparatory or auxiliary nature that do not constitute a PE even if the conditions of article 5(1) of the OECD model are met and the activity is carried on through a fixed place of business. Auxiliary activities are different from preparatory activities in the sense that the auxiliary activities accompany the core business activity while the preparatory activities precede the core activity.[13] An activity that has a preparatory character is, as paragraph 60 of the article 5 commentary explains, generally one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole.

Thus, in contrast to core business activities, preparatory or auxiliary activities may not constitute a PE — a concept explained in paragraph 58 of the commentary on article 5 of the OECD model.[14] This rule is in accordance with the final report on BEPS action 7.

The OECD added a new paragraph 4.1 to article 5 in 2017. It complements paragraph 4 and — as paragraph 58 of the commentary on the article notes — ensures that the preparatory or auxiliary character of activities carried on at a fixed place of business is viewed in light of other activities that constitute complementary

[9] *See* Sasseville and Skaar, *supra* note 5.

[10] Petra Eckl, "Generalthema I: Die Definition der Betriebsstätte," *IStR* 512 (2009).

[11] *See* Alessandro Caridi, "Proposed Changes of the OECD Commentary on Article 5: Part II — The Construction PE Notion, the Negative List and the Agency PE Notion," 43(1) *Eur. Tax'n* 38 (Feb. 2003).

[12] Brian J. Arnold, "Time Thresholds in Tax Treaties," 62(6) *Bull. for Int'l Tax'n* 226 (June 2008).

[13] *See* Sasseville and Skaar, *supra* note 5, at 40.

[14] *See id.*; and Franz Wassermeyer, Ulf Andresen, and Xaver Ditz, *Betriebsstätten Handbuch* 204 (2006).

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functions and are part of a cohesive business that the enterprise or a closely related enterprise carries on in the same state. Paragraph 79 of the commentary on article 5 explains that this provision prevents an enterprise or a group of closely related enterprises from fragmenting a cohesive business operation into several small operations and arguing that each is merely engaged in a preparatory or auxiliary activity. However, contracting states are free to either include the new provision in their bilateral tax treaties or rely on the previous version of the OECD model.

E. Dependent Agent PEs

Paragraphs 5 and 6 of article 5 of the OECD model address when activities carried on by an agent or another person acting on behalf of an enterprise can create a PE. The objective of article 5(5) of the model is to ensure equal tax treatment of enterprises that perform activities in the source state using a person instead of a fixed place of business. If the conditions of paragraph 5 are fulfilled, the provision will treat a person as dependent agent, and the profits allocated to that agent's business will be treated in the same manner as the profits attributed to fixed places of business under article 5(1) of the OECD model.[15] This principle is discussed in paragraphs 82-84 of the commentary on article 5 of the 2017 OECD model.

Under article 5(5) of the OECD model, a person (an individual or a company) is deemed to create a PE of the enterprise if that person has and habitually exercises authority to conclude contracts that are binding on the enterprise even if the enterprise may not have a fixed place of business in that state — a so-called agency PE, as elaborated upon in paragraphs 82-84 of the commentary on article 5 of the 2017 OECD model. An agency PE under article 5(5) exists when the activities of an enterprise would not otherwise be attributed to a PE as defined under the basic rule provided in article 5(1) of the OECD model. To qualify, the agent does not need to be a resident of the source state or have a place of business therein. However, the business contracts in the state must be sufficient to create a taxable presence. Though this threshold is debatable, paragraph 98 of the commentary on article 5 of the 2017 OECD model indicates that a transient presence does not generally suffice.

The 2017 revision of the OECD model and the related commentary significantly broadened the scope of dependent agent PEs to include commissionnaire arrangements.

III. PEs Under Luxembourg Tax Law

A. Opening Comments

The definition of a PE for Luxembourg tax law is in section 16 of the Fiscal Adaptation Law (Steueranpassungsgesetz, or StAnpG), which provides both a general PE definition (paragraph 1) and a non-exhaustive list of examples (paragraph 2) that are deemed to constitute a PE for Luxembourg tax purposes. Paragraphs 3 and 4 deal with specific industries such as railroads.

The PE concept affects both Luxembourg residents and nonresidents. When Luxembourg nonresidents have a PE in Luxembourg, the profits attributable to that PE are subject to individual income tax (LITL article 2(3), in conjunction with LITL article 156 No. 1 a) or corporate income tax (LITL article 160(1), in conjunction with LITL articles 162(1) and 156 No. 1 a) and municipal business tax (municipal business tax law (Gewerbesteuergesetz), section 2(1) and (2)). Moreover, nonresident companies are subject to Luxembourg net wealth tax levied on the unitary value (an adjusted net asset value) of their Luxembourg PE (Net Wealth Tax Law section 2(1), No. 2, (2)).

There are only a few Luxembourg court decisions that examine the definition of a PE under Luxembourg's tax laws. Various sources, however, endorse the use of German case law — including decisions from Germany's Federal Tax Court (Bundesfinanzhof, or BFH) — as a resource for interpreting the StAnpG given its German origin.

B. The General PE Definition

According to the general PE definition in StAnpG section 16(1):

> A permanent establishment in the sense of tax law is every fixed place of equipment

[15] *See* Sasseville and Skaar, *supra* note 5.

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or business facility which serves for the operation of an established business.

Thus, to meet the definition of PEs under Luxembourg tax law, an entity must fulfill the following conditions:

- the existence of a "place of equipment or business facility" — that is, a facility or, in some cases, machinery or equipment;
- this place of equipment or business facility must be "fixed" — that is, it must be established at a distinct place with a sufficient degree of permanence; and
- the carrying on of the business of the enterprise through this fixed place of equipment or business facility.[16]

1. A Place

"A fixed place of equipment or business facility" may be any premises, facility, or installation that serves the business activities of a nonresident enterprise, regardless of whether the facilities are suitable for the presence of people.

Even a simple storage area, a pipeline, or an internet server may constitute a PE for Luxembourg tax purposes.

Ultimately, whether specific premises, facilities, or installations qualify as a place of equipment or business facility within the meaning of the PE provision depends on the specific activities that the enterprise carries out.

To qualify as a PE, the taxpayer must maintain the fixed place of equipment or business facility for more than a temporary period. According to the BFH (Decision of Feb. 3, 1993, BStBl. II 1993, 464), this rule requires that the taxpayer have a legal right in the property that cannot be revoked or changed without the taxpayer's consent. It does not, however, require ownership of the property. Examples of arrangements that may suffice to create a PE — assuming that the use is for the carrying out of business activities — include:

- a rental (BFH, Decision of Jan. 30, 1974, BStBl. II 1974, 327);
- a sublet (BFH, Decision of Nov. 26, 1986, BStBl. II 1986, BFH/NV 1988, 82);
- leasehold (BFH, Decision of Oct. 28, 1977, BStBl. II 1978, 1160; or
- gratuitous cession (BFH, Decision of Jan. 30, 1974, BStBl. II 1974, 327).

However, simply carrying out activities in the premises of a business partner will not fulfill the control requirement (BFH, Decision of Oct. 11, 1989, BStBl. II 1990, 166).

2. Fixed

To qualify as a PE for tax purposes in Luxembourg, the equipment or business facility must be fixed in terms of geographical location. Permanent business facilities or equipment definitely includes buildings, office premises, and other facilities that are permanently attached to the ground. In contrast, since trucks, ships, and aircraft are not fixed, they do not come under the definition of fixed place of equipment (BFH, Decision of Feb. 13, 1974, BStBl. II 1974, 361).

Notably, however, facilities do not need to be permanently attached to the ground to qualify as a PE. Transportable facilities such as mobile newspaper stands, maintenance vehicles, camping trailers, or tents may be fixed within the meaning of this provision insofar as they are located permanently or frequently (over a longer period of time) at a specific location.

There is no decisive period for the "permanency test." As a practical guideline, a period of six months — analogous to the time threshold for building and construction sites — can be used, but it is not a binding rule. The BFH has explained that the period for which the taxpayer planned to use the fixed place of equipment or business facility is irrelevant for the six-month threshold — in this case, the factual duration is more important than the intention of the taxpayer (BFH, Decision of May 19, 1993, BStBl. II 1993, 655). German case law also holds that a fixed place of equipment or business facility should generally not constitute a PE if the taxpayer's activities are of a unique or short-term nature (BFH, Decision of Oct. 30, 1974, BStBl. II 1974, 107; and BFH, Decision of Mar. 18, 1976, BStBl. II 1976, 365).

3. Operation of Business

The fixed place of equipment or business facility must "serve for the operation of an established business" to qualify as a PE under Luxembourg's tax law. The use of the term "established business" clarifies that the PE

[16] *See* Hoor, *supra* note 8, at 14.

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concept is only relevant for commercial activities as defined in LITL article 14(1).[17] Therefore, absent a commercial business, activities such as investments in real estate, the renting of tangible assets, or the licensing of intangible assets will not constitute a PE.

Whether the fixed place serves the main purpose of the business or is ancillary thereto is irrelevant for the existence of a PE as long as it serves the business of the nonresident enterprise. Further, employees of the nonresident enterprise do not necessarily need to be the individuals who carry out the commercial activity. Instead, the business may be able to subcontract the activities to independent contractors. Courts have, at least in some cases, found that a fixed place of equipment or business facility that is fully automated or mechanical and does not often require the presence of staff may still constitute a PE (BFH, Decision of Oct. 12, 1977, BStBl. II 1978, 160; BFH, Decision of Oct. 30, 1996, BStBl. II 1997, 12; and BFH, Decision of May 25, 2000, BStBl. II 2001, 365).

Overall, the threshold that must be met to constitute a PE in accordance with the definition provided in StAnpG section 16(1) is rather low.

C. Specific PE Examples in StAnpG Section 16(2)

Section 16(2) of the StAnpG contains a non-exhaustive list of examples that are deemed to constitute a PE under Luxembourg's tax law.

The most important examples are:

- the place of corporate management;
- branch offices;
- factories;
- warehouses;
- places of purchase and sale;
- permanent agents; and
- building and construction sites or installation projects.

Regardless of whether the criteria in StAnpG section 16(1) are met, these facilities always constitute a PE. While most of these examples will meet the definition in section 16(1), some examples extend the scope of the PE definition.

D. The New Provision Relating to Foreign PEs

As part of the 2019 tax reform, Luxembourg extended the PE definition by adding a fifth paragraph dealing with foreign PEs of Luxembourg taxpayers. According to the new provision, the only criteria to be considered when assessing whether a Luxembourg taxpayer has a PE in a country with which Luxembourg has concluded a tax treaty are the criteria in the applicable tax treaty. Thus, the tax treaty's definition of a PE will be relevant to the question of whether a Luxembourg taxpayer has a foreign PE.

According to StAnpG section 16(5), the tax law will only consider a taxpayer to carry on all or part of its business through a PE situated in the other contracting state to the extent that the activity performed — viewed in isolation — constitutes a separate activity and represents a participation in the general economic life of the other contracting state, unless a specific provision in the applicable tax treaty provides otherwise.

Under the new rules, the Luxembourg tax authorities may ask Luxembourg taxpayers to provide confirmation (for example, a certificate of registration) that the other contracting state considers the entity to be a PE. However, taxpayers must provide this confirmation when the applicable tax treaty does not allow Luxembourg, as the residence state of the enterprise, to decline the tax exemption of the income or capital and the other contracting state interprets the tax treaty in a way that excludes or limits its own taxing right.

The new provision resembles article 23A(4) of the OECD model, which allows the residence state of a taxpayer to deny the application of the exemption method if the other contracting state interprets the tax treaty in a way that restricts or excludes its own taxing rights. The goal of this provision is to avoid double nontaxation in case of conflicts of interpretation by the two contracting states.

IV. Analysis of the New Provision and Circular

The new rules on foreign PEs — that is, StAnpG section 16(5) and the related circular — appear to change Luxembourg's approach to PEs in outbound cases by including additional requirements. The purpose of this new provision

[17] *See* Section IV.C, *infra*.

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is to avoid conflicting interpretations caused by the interaction between domestic tax law and the provisions of a tax treaty.

But does the amended PE definition truly introduce any requirements that did not exist before? Moreover, can Luxembourg unilaterally eliminate its obligation to exempt profits attributable to a PE in a tax treaty jurisdiction by changing domestic tax law?

A. Role of Article 23A(4) of the OECD Model

The new paragraph 5 to StAnpG section 16 refers to situations when a treaty partner interprets the provisions of the tax treaty in a way that would exclude or limit that jurisdiction's taxing rights. This language is inspired by article 23A(4) of the OECD model, and the circular refers to that provision.

The OECD first included article 23A(4) in the 2000 revision of the OECD model. The purpose of article 23A(4) of the OECD model convention is to avoid double nontaxation resulting from disagreements between the contracting states on the facts of a case or on the interpretation of the distributive rules in articles 6 through 22 of the OECD model.[18]

Article 23A(4) of the OECD model applies when both of the following occur:

- The source state interprets the facts of a case or the provisions of the convention in such a way that eliminates its right to tax an item of income or capital — such as when the source state interprets a distributive rule as allocating an exclusive taxing right to the residence state — or limits the tax that it can levy — such as when the source state classifies an item of income as dividends (article 10(2) of the OECD model) or interest (article 11(2) of the OECD model).
- The residence state adopts a different interpretation of the facts or of the provisions of the convention, and its interpretation of the convention holds that the other contracting state can tax the item. Thus, if article 23A(4) of the OECD model did not exist, the residence state would need to exempt that item of income or capital.[19]

Accordingly, the income and capital would either not be taxed at all or, in case of dividends and interest, be taxed at a limited rate in the source state. In these circumstances, as paragraph 56.1 of the commentary on articles 23A and 23B of the OECD model explains, article 23A(4) of the OECD model confirms the taxing right of the residence state and double taxation is avoided via application of the credit method.

The circular states that Luxembourg has included a provision similar to article 23A(4) of the OECD model in about 40 of its tax treaties. Luxembourg has also signed the multilateral instrument that the OECD developed as part of BEPS action 15 as a way to implement tax-treaty-related BEPS measures into bilateral tax treaties. Luxembourg generally adopted only the minimum standards — namely, an amended preamble and the principal purposes test. However, Luxembourg adopted a provision drafted along the same lines as article 23A(4) of the OECD model. Thus, this provision might apply to other bilateral tax treaties that do not yet include such a provision if the other contracting state adopted the same implementation option.

Regardless, this provision and those like it only apply if the PE's host state believes that the treaty restricts its taxing right. Whether or not the host state effectively taxes the profits attributable to the PE is wholly irrelevant for the purposes of article 23A(4) of the OECD model. The circular acknowledges the same point. Thus, if the host state of the PE simply does not exercise a taxing right provided under the tax treaty, this provision cannot be used to justify the application of the credit method.

B. Tax Treaties and Domestic Tax Law

Domestic tax law and tax treaty law are two independent and functionally distinct legal spheres. While domestic law determines the objects and scope of domestic tax liabilities, tax treaty law only determines which of the two

[18] *See* Hoor, *supra* note 2, at 204.

[19] *See* articles 23A and B, para. 56.1 of the commentary on the OECD model.

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contracting states is entitled to actually exercise the taxing rights under its domestic tax law.

As paragraph 3 of the commentaries to article 13 of the OECD model treaty explains, tax treaties can never generate taxing rights under domestic tax law or impose a higher charge than domestic law provides. Rather, as *lex specialis* vis-à-vis the domestic tax provisions, tax treaties can only restrict the taxing rights that domestic tax law provides or relieve an entity from tax. Domestic tax law remains unaffected as long as those rights have not been limited by the treaty. Put another way: Tax treaties only describe the permissible boundaries of the tax system, not the actual tax system itself.[20]

In addition to not dictating that allocated taxing rights must be exercised by a country, tax treaties also do not dictate how those rights are to be exercised — except in some cases to ensure their effectiveness, such as the application of the "functionally separate enterprise approach" and the arm's-length principle in accordance with article 7(2) of the OECD model. Whether and how taxing rights are exercised is usually left to ordinary domestic laws. It is therefore possible and even common to have a situation in which there is a right under a treaty to impose some form of taxation but the domestic legislature has not decided to impose — or has actively decided not to impose — a tax liability under domestic law.

Applied to PEs, this means that a contracting state may not make use of its taxing right provided under articles 5 and 7(2) of the OECD model because the other contracting state has a more restrictive concept of trade or business under its domestic tax law.

When new legislation is being proposed, its consistency with the state's treaty obligations is sometimes an issue. A jurisdiction may only exercise its taxing rights if — and to the extent that — they are not restricted under a tax treaty. Notably, the scope of a state's taxing rights may not be the same across all of its tax treaties — some treaties may restrict specific taxing rights while others do not.

From the taxpayer's standpoint, if one contracting state opts not to exercise its full taxing rights, the tax treaty at least serves as a guarantee that future taxation cannot go beyond the level fixed by the treaty — at least, unless the tax treaty is first abrogated or amended.[21]

C. Domestic Interpretation of the Term 'Business'

The circular states that Luxembourg may refer to domestic tax law when interpreting terms that are not defined in a tax treaty. This is consistent with article 3(2) of the OECD model convention, which provides that any undefined term in the tax treaty will have the meaning that it has under the law of the contracting state applying the tax treaty, unless the context requires otherwise.[22]

Luxembourg's new PE definition provides that a Luxembourg taxpayer is only considered to have a PE in the other contracting state if the activity on its own is an independent activity that represents a participation in the general economic life of the other state. This suggests that the PE should perform an activity that comes within the scope of a commercial activity under Luxembourg tax law.

According to LITL article 162(3), any activity performed by a Luxembourg company is deemed to be a commercial activity. One could argue that any activity that a Luxembourg company performs via a fixed place of business in the other contracting state is part of the business of the Luxembourg company and therefore constitutes a PE within the meaning of the tax treaty.

However, according to StAnpG section 16(5), a foreign PE of a Luxembourg company has to — on its own — perform a commercial activity. LITL article 14(1) states that the carrying out of a commercial activity requires cumulatively: (1) an independent activity (2) of permanent character (3) that is carried out with the intent to realize profits and (4) involves participation in the general economic life.

Circular L.I.R. No. 14/4, which the Luxembourg tax authorities released January 9, 2015, analyzes the concept of commercial activity and provides guidance on the interpretation of these criteria. It also refers to parliamentary

[20] *See* Hoor, *supra* note 2, at 42.

[21] *See* Philip Baker, *Double Taxation Conventions and International Tax Law* 7 (1994).

[22] *See* article 3, para. 11 of the commentary on the OECD model; and Hoor, *supra* note 2, at 48.

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briefing documents, Luxembourg case law, and German case law as sources for guidance.[23]

1. Independent Activity

The independent activity criterion assumes that the taxpayer carries out an activity in its own name and on its own behalf (BFH, Decision of Jan. 17, 1973, BStBl. II 1973, 260). The taxpayer also needs to be able to exercise business initiative and bear the risk of the activity, which includes the fact that that the profits or losses deriving from the activity are directly allocated to the taxpayer (BFH, Decision of Feb. 13, 1980, BStBl. II 1980, 303; BFH, Decision of July 31, 1990, BStBl. II 1991, 66; and BFH, Decision of Sept. 24, 1991, BStBl. II 1992, 330).

2. Permanent Character

The notion of permanence distinguishes commercial activity from one-time transactions and wealth management. Case law often finds that an activity meets the permanence criterion if, from the beginning, there is an intention to carry out a lasting activity that should result in a source of income. Permanence does not, however, require a particular minimum period or that an activity be performed without interruptions — a temporary or recurring activity may suffice. Although one-time transactions do not amount to a permanent activity, a one-time transaction may have a permanent character based on the intent to repeat the activity if an opportunity arises.

Given that a PE only exists when a fixed place of business has a degree of permanence, it should generally meet the second criterion for carrying on a business.

3. Carried Out With Intent to Realize Profits

The third element of the test for carrying on a business is that the entity must undertake the activity with the intent to realize profits. Whether the PE realizes losses during the start-up phase or at other times is irrelevant. The decisive factor is that the taxpayer intends to realize an overall profit during the period when it carries out the activity, another point that finds support in German case law (BFH, Decision of June 25, 1986, BStBl. II 1984, 751).

As companies are deemed to have a profit motive, PEs should frequently meet this criterion.

4. Participation in the General Economic Life

The fourth criterion overlaps somewhat with both the criteria of permanence and the intent to realize profits. The intent is to distinguish commercial activities from wealth management. The commercial activity must be part of the general economic life of the host country: In other words, the enterprise must take part in the provision of goods or services to the market, and its activity must be visible to the general public.

Notably, the commentaries on the PE definition in the draft law regarding the 2019 tax reform specifically stated that the management of financial assets or intangibles would not be considered a participation in the general economic life of a contracting state and therefore may not be sufficient to constitute a PE. However, in comments that it released November 13, 2018, the State Council clearly stated that this stance would be too restrictive and mere asset management should suffice to constitute a PE. In the circular, the Luxembourg tax authorities — in accordance with the State Council's comments — did not subject the existence of foreign PEs to the requirement that an activity exceed mere asset management. Likewise, the OECD commentary confirms that for a place of business to constitute a PE, the enterprise using the PE must carry on its business wholly or partly through it. However, article 5, paragraph 35 of the OECD's commentary clearly states that the activity does not need to be of productive character.

The existence of an organization, physical substance, or publicity may suggest that an entity meets the fourth criterion. Whether the activity only involves a limited circle of customers is irrelevant — one customer may suffice and, in a group company context, a PE may exist even if it only does business with affiliates.

D. Illegitimate Tax Treaty Override

An issue that is closely linked with the interpretation and application of tax treaties is treaty override. The term "treaty override" refers to the enactment of subsequent domestic

[23] *See* Hoor and Keith O'Donnell, "The New Luxembourg Circular on the Tax Treatment of Limited Partnerships (SCS/SCSp)," *AGEFI* 27 (Feb. 2015).

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legislation that conflicts with obligations the jurisdiction undertook in a prior, binding tax treaty. Conflicting domestic legislation may, for example, take the form of a provision that treaty provisions are to be disregarded in specified circumstances.[24]

Two situations need to be distinguished:

- an intentional treaty override occurs when one state knowingly and intentionally enacts legislation that conflicts with a treaty obligation; and
- an unintentional treaty override occurs when that intention does not exist.

With an unintentional treaty override, it may be possible to reconcile the tax treaty and the domestic law. In contrast, as the OECD treaty override report indicates, when an intentional treaty override occurs, the conflict is manifest and the issue becomes whether the changes in domestic law prevail.

Importantly, a tax treaty is an international treaty that is binding on the contracting states. Consequently, the subsequent enactment of domestic legislation that is intended to override a treaty constitutes a breach of international law and a state's international obligations. In this regard, articles 26 and 27 of the Vienna Convention on the Law of Treaties provide clear rules on the performance of treaties. According to article 26 of the Vienna Convention, every treaty in force is binding upon the parties to it and they must perform the obligations in good faith. Furthermore, article 27 of the Vienna Convention explicitly states that a party to a treaty may not invoke provisions of its internal law as justification for its failure to perform a treaty.[25]

As the OECD treaty override report sets out in paragraphs 21 through 26, the overriding of a treaty provision by domestic law may lead to a complaint under the mutual agreement procedure of the treaty, to a reference to an international arbitral body, or to the termination of the treaty by the other party.

[24] *See* Hoor, *supra* note 2, at 44; and OECD, "Recommendation of the Council Concerning Tax Treaty Override" (Oct. 2, 1989) (OECD treaty override report).

[25] *See* Hoor, *supra* note 2, at 44.

When profits are attributable to a PE located in a contracting state, Luxembourg frequently adopts the exemption method for the elimination of double taxation. The application of the exemption method is generally not conditioned on effective taxation in the other contracting state. Thus, Luxembourg has to exempt the income unless a specific clause in the tax treaty allows Luxembourg to deny the exemption in the absence of effective taxation in the PE's host state such as a subject-to-tax provision or a switchover clause that provides for the application of the credit method. Otherwise, denying the application of the exemption method when a Luxembourg company has a valid PE in a contracting state would represent illegitimate tax treaty override.

E. Confirmations to Be Produced by Taxpayers

The February circular also dictates how taxpayers must provide evidence of a foreign PE. According to the circular, Luxembourg's tax authorities can always request a confirmation that the host state of the PE recognizes the PE. This evidence might, for example, be a registration of the PE in the other contracting state. This is consistent with a taxpayer's general duty to cooperate: Article 171 of the General Tax Code (Abgabenordnung) provides that taxpayers must, upon request, provide evidence that the statements made in the tax returns are correct. The relevant documents should be annexed to the corporate tax returns.

If the applicable tax treaty does not allow Luxembourg to deny the application of the exemption method or the other contracting state interprets the provisions of the tax treaty in a way that limits or excludes its taxing right, then the taxpayer must produce evidence confirming the existence of the PE in the other contracting state. Should the taxpayer fail to produce appropriate evidence, the Luxembourg tax authorities will consider that the Luxembourg taxpayer has no PE in the other contracting state.

Regarding the type of information that will fulfill the taxpayer's obligation, the circular states that a taxpayer must produce a document that proves that the competent authorities of the other contracting state consider there to be a PE. This might be a tax assessment or a certificate in which

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the competent authorities of the other contracting state confirm the existence of a PE.

According to the circular, producing a certificate that confirms the existence of a commercial activity in the territory of the other contracting state would not suffice if that activity does not constitute a PE. However, if the other contracting state does not make use of its taxing right provided under the tax treaty, Luxembourg cannot unilaterally decide to refuse the application of the exemption method unless the treaty includes a specific antiabuse provision.

F. Analysis of the Amended PE Definition

The question arises: Does the amended PE definition introduce a new requirement for foreign PEs of Luxembourg taxpayers, or does the new provision merely clarify and formalize the requirements that already existed?

According to the amended PE definition, the only criteria to consider when analyzing whether a Luxembourg taxpayer has a PE in a treaty jurisdiction are the criteria in the applicable tax treaty. This is consistent with the general principle that in a tax treaty context, a PE only exists if — and thus the host state only has an unlimited primary taxing right over a nonresident enterprise's business profits when — a nonresident enterprise has a PE in accordance with the applicable tax treaty.

Regarding the interpretation of the term "business" under Luxembourg tax law and article 3(2) of the OECD model, the amended PE definition is merely a clarification. The concept of commercial activity did not change — and the concept was already relevant under article 3(2) of the OECD model before the amendment to the domestic PE definition.

Moreover, article 23A(4) of the OECD model cannot be used to eliminate double nontaxation if both contracting states hold that the profits attributable to the PE "may be taxed" by the host state of the PE regardless of whether the latter exercises its taxing right.

Likewise, Luxembourg tax authorities already had the right to request evidence and documentation from Luxembourg taxpayers proving they have a valid PE in a treaty jurisdiction — this was already part of a taxpayer's cooperation duty.

Thus, the new paragraph 5 to StAnpG section 16 merely confirms requirements that already existed before Luxembourg amended its PE definition. Taxpayers may, however, be wise to expect that the Luxembourg tax authorities will take even more care than they did in the past when determining whether an entity satisfies the criteria of the PE definition in an applicable tax treaty.

V. Case Study: The McDonald's Case

A. Background

The PE concept has also been a key point in the European Commission's state aid investigations involving the McDonald's case. McDonald's is a large U.S. multinational with McDonald's Corp., a company listed on the New York Stock Exchange, at the head. McDonald's Corp. and its U.S. affiliate, McDonald's International Property Co., grant licenses on a market-by-market basis that allow entities — most of which are either direct or indirect subsidiaries of McDonald's Corp. — to develop and operate restaurants in most major markets outside the United States.[26]

McD Europe Franchising Sàrl (McD Europe) is a Luxembourg company with branches in the United States and Switzerland. To enable McD Europe to provide centralized oversight and management of all European franchise rights, McDonald's Corp. and McDonald's International Property Co. entered into two agreements with the Swiss branch: a buy-in agreement and a qualified cost-sharing arrangement.

The buy-in agreement allowed McD Europe to participate in some existing and to-be-developed franchise rights that McDonald's Corp. and McDonald's International Property Co. owned. Thus, McD Europe became the beneficial owner of several franchise rights intangibles. McD Europe eventually allocated these rights and the related obligations to its U.S. branch.

A manager located in the United States controlled the operations of McD Europe's U.S. branch and oversaw some of the activities

[26] *See* Hoor and Keith O'Donnell, "McDonald's State Aid Investigation: What the European Commission Got Wrong," *Tax Notes Int'l*, Sept. 12, 2016, p. 975.

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connected with the franchise rights. McDonald's Corp. provided this manager to the branch on a part-time basis in accordance with a service agreement in return for a cost-plus charge.

The Swiss branch, which had its registered office in Geneva, licensed franchise rights to franchisers in various European jurisdictions. The branch also provided management, support, development, and other services in connection with the franchise rights. The U.S. branch compensated the Swiss branch for these services on a cost-plus basis. The franchisers paid royalties to the Swiss branch, and it paid the royalties on to the U.S. branch since the U.S. branch held the franchise rights intangibles. Compensation for the services that the Swiss branch provided was reflected in the difference between the royalties it received and those it paid on to the U.S. branch.

The figure shows the relevant entities of the McDonald's group and the major fund flows.

B. Tax Treatment in Luxembourg and the U.S.

As a Luxembourg resident company, McD Europe is subject to Luxembourg corporate income tax on its worldwide income. In principle, income attributable to the U.S. branch is part of McD Europe's taxable income. However, because the branch is a PE in the United States, the Luxembourg-U.S. double tax treaty grants the United States unlimited primary taxing rights over profits attributable to the U.S. branch. Therefore, Luxembourg has to exempt income attributable to a U.S. PE.

Two tax rulings that the Luxembourg tax authorities signed in March and September 2009 detail the tax treatment of McD Europe.

Under U.S. tax law, income that a Luxembourg company derives through a U.S. branch is not automatically taxable in the United States. Instead, for the United States to be able to tax the income, it must be "effectively connected with a U.S. trade or business." Accordingly, there may be cases — such as the McDonald's case — when Luxembourg considers a PE to exist under its domestic law and the governing tax treaty, but there is no taxable presence from a U.S. tax perspective. In other words, U.S. domestic tax law does not exercise taxing rights that the applicable treaty allocates to the United States.

Consequently, the income that McD Europe realized through its U.S. branch was taxable in neither the United States nor Luxembourg, which applied the exemption method for business profits attributable to the PE in the United States.

C. Comments of the Luxembourg Tax Authorities

The Luxembourg tax authorities submitted their comments on the opening decision of the state aid investigation February 4, 2016. A summary of these comments appears in paragraphs 69 through 80 of the European Commission's final decision on tax rulings granted by Luxembourg in favor of McDonald's Europe (Commission Decision C(2018) 6076 final (Sept. 19, 2018)).

In essence, the Luxembourg tax authorities advanced three arguments:

- first, that the commission incorrectly identified the legal framework;
- second, that the commission's reasoning in the opening decision was fundamentally flawed; and
- third, that the commission has not proven the existence of a selective advantage.

The Luxembourg tax authorities began by setting out the objective and content of the Luxembourg-U.S. tax treaty — namely, the allocation of taxing rights to prevent (actual or potential) double taxation. Notably, the objective did not include ensuring the actual taxation of the taxpayer by one of the contracting states or by a third state.

Moreover, a tax treaty does not give rise to taxation if no taxation is provided for in national law. The exercise of the power of taxation is within the exclusive competence of the contracting state to which that power has been allocated by the tax treaty. Absent a switchover clause, a subject-to-tax clause, or the use of the credit method, one contracting state cannot unilaterally resolve a case of nontaxation if the other state does not exercise its power to tax. Instead, Luxembourg argued that the only way to resolve situations of nontaxation was to amend the tax treaty. Indeed, if Luxembourg were to tax profits attributable to the U.S. PE of McD Europe, Luxembourg would not be honoring its obligations under the tax treaty.

The Luxembourg tax authorities further explained that a tax treaty is interpreted independently by each contracting state.

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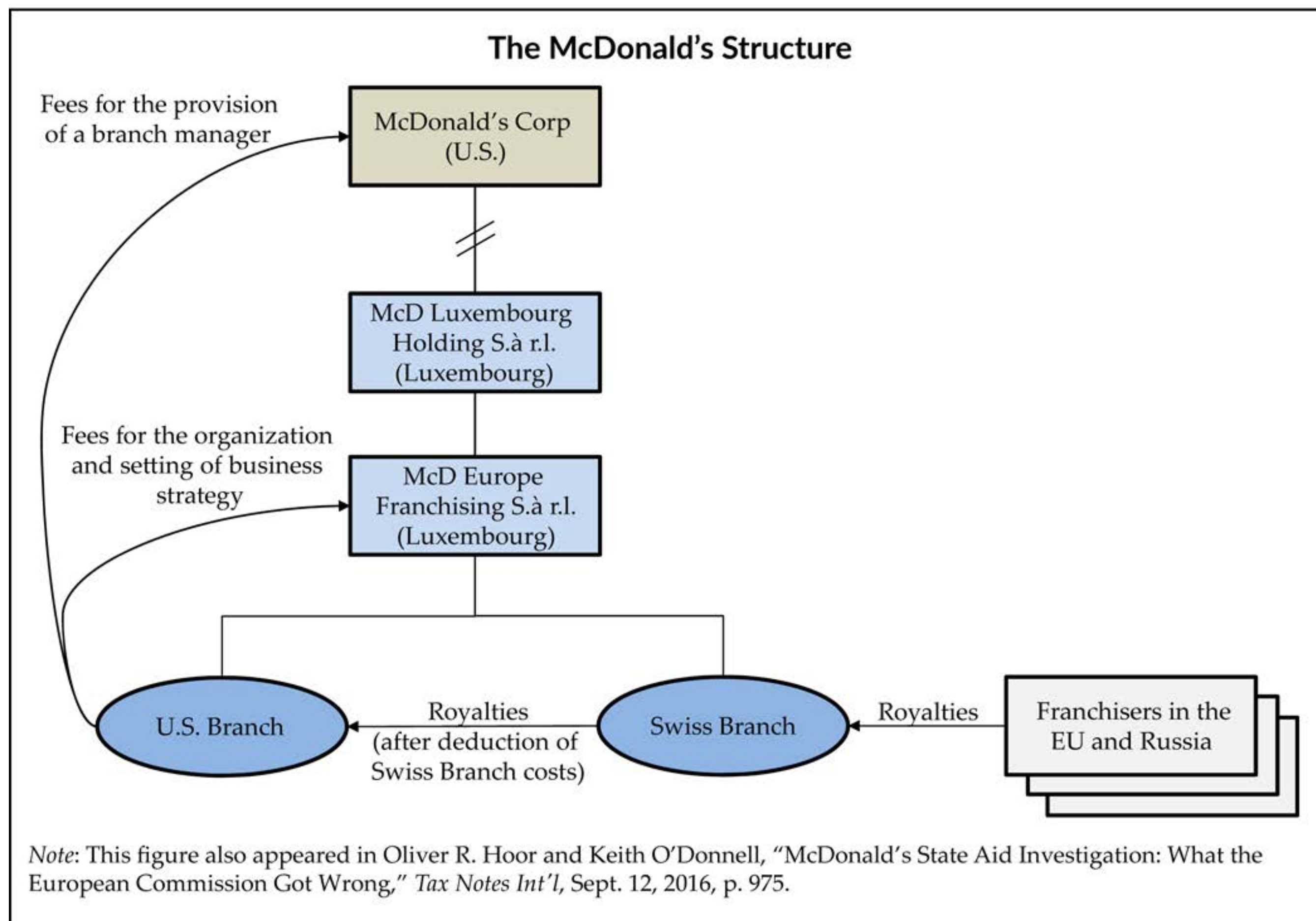

Note: This figure also appeared in Oliver R. Hoor and Keith O'Donnell, "McDonald's State Aid Investigation: What the European Commission Got Wrong," *Tax Notes Int'l*, Sept. 12, 2016, p. 975.

Therefore, Luxembourg could not be expected to interpret the tax treaty concluded with the United States by reference to U.S. law.

Also, the Luxembourg tax authorities explained that Luxembourg's tax law does not include a principle of actual taxation. Luxembourg courts confirmed as much in the La Costa judgments, which note that double nontaxation may occur despite the correct application of a tax treaty because the contracting states are independently interpreting the treaty.[27] Therefore, the double nontaxation in the McDonald's case was the result of U.S. law and the concept of effectively connected income. Luxembourg's reasoning is consistent with the analysis in this article.

D. Decision of the European Commission

On September 19, 2018, the European Commission issued a press release announcing its decision in the McDonald's state aid investigations. The commission's in-depth analysis shows that the reason for double nontaxation in this case was a mismatch between Luxembourg and U.S. tax laws as well as the applicable tax treaty. It was not the result of special treatment in Luxembourg, and therefore Luxembourg did not violate EU state aid rules.

In other words, the European Commission's decision confirms that the tax rulings that the Luxembourg tax authorities granted did not entail a selective tax benefit and merely provided certainty on the general tax treatment in these circumstances.[28] Double nontaxation was the

[27] Tribunal Administratif (Luxembourg Court of First Instance), Decision No. 12831 (Dec. 3, 2001); and Cour Administrative (Luxembourg Court of Second Instance), Decision No. 14442c (Apr. 23, 2002).

[28] *See* Hoor, "Insight: European Commission Finds No Illegal State Aid," Bloomberg Tax (Nov. 23, 2018).

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result of the correct application of the tax rules in force.

Regarding the existence of a PE in the United States, the commission concluded in paragraph 115 of the final decision that McD Europe's activities created a PE under StAnpG section 16. In the same paragraph, the commission found that "it is not established that the Luxembourg tax authorities misapplied the double taxation treaty by considering that the income of the US Franchise Branch 'may be taxed' in the US according to Articles 7(1) and 25(2)(a) of the Luxembourg-US double taxation treaty."

As paragraph 117 of the final decision notes, in its opening decision the commission had raised doubts regarding whether the double nontaxation of McD Europe's franchise income was a result of a difference in interpretation between Luxembourg and the United States or a conflict of qualification when applying the tax treaty. A conflict of qualification occurs when the contracting states apply different articles of the tax treaty based on the interaction of domestic tax law with the convention. In those circumstances, the commentary to the OECD model states that the residence state has to consider the qualification in the source state. Accordingly, as paragraph 119 of the final decision explains, if the source state's perspective is that it has no right to tax an item of income in accordance with the provisions of the tax treaty, then the residence state is not required to exempt the income.

In contrast, differences in interpretation or factual assessment refer to how the contracting states interpret the tax treaty or apply it to a given set of facts — that is, issues unrelated to domestic law. Paragraph 120 of the final decision notes that the OECD included article 23A(4) in the model treaty to tackle cases of double nontaxation that stem from differences of interpretation.

The commission acknowledged that it found no evidence to support the idea that the McDonald's case might concern a conflict of qualification. The different interpretations of the term "business" under Luxembourg and U.S. law did not lead the countries to apply different provisions of a tax treaty to the same matter, but instead to interpret the same provision — article 5 of the tax treaty — differently.

According to the commission, double nontaxation may arise from differences in interpretation when the applicable tax treaty does not include a provision like article 23A(4) of the OECD model. The commission suggested that double nontaxation arising from differing interpretations of the tax treaty can be resolved by negotiating an amendment to the tax treaty or using MAP in article 27 of the tax treaty. Further, the commission proposed that double nontaxation may be resolved by amending StAnpG section 16 so that Luxembourg would only find that a PE exists if the business activities also constitute a PE under U.S. law.

While the commission is correct in its assessment that the double nontaxation in the McDonald's case is the result of the correct application of Luxembourg tax law, U.S. tax law, and the applicable tax treaty, it is incorrect in its contention that this situation could be resolved through the inclusion of article 23A(4) of the OECD model. Both the United States and Luxembourg apply the same provisions to this matter and the United States does not consider its taxing right to be restricted in any way by the treaty. Article 23A(4) of the OECD model would not apply in these circumstances. Furthermore, MAP is not helpful absent a disagreement regarding the interpretation of the tax treaty. Last but not least, amending the PE definition — as the commission suggested in paragraph 122 — would simply be an illegitimate tax treaty override.

VI. Conclusion

The new provision that Luxembourg has included in its domestic PE definition concerns situations in which Luxembourg taxpayers have a PE in a country with which Luxembourg has concluded a tax treaty. The basic goal of this amendment is to eliminate conflicts of interpretation resulting from the interaction between the domestic PE concept and the PE definition included in tax treaties.

According to the amended PE definition, the only criteria that the authorities will consider when assessing whether a Luxembourg taxpayer has a PE in the jurisdiction of a tax treaty partner are the criteria defined in the applicable tax treaty. Moreover, a Luxembourg taxpayer will only be deemed to carry out business in the other contracting state if the activity — standing on its own — qualifies as an independent activity that

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represents a participation in the general economic life of that other state.

But these requirements existed already, even if they were not formally spelled out in the PE definition. In the McDonald's state aid decision, the European Commission confirmed that Luxembourg correctly applied both its domestic tax law and the governing tax treaty. Ultimately, double nontaxation of the sort that occurred in the McDonald's case can only be resolved by amending the applicable tax treaty itself to include specific antiabuse rules such as a subject-to-tax or a switchover clause that result in the application of the credit method when profits are not taxed in the PE's host state. ■

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