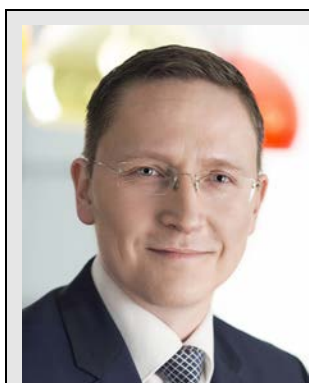


The Concept of Substance in a Post-BEPS World

by Oliver R. Hoor



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In this article, the author analyzes the importance of substance in international tax law and how it has been reshaped by the OECD's base erosion and profit-shifting project.

Luxembourg is a prime holding location and a major financial center that features a large fund industry. Whenever Luxembourg companies are involved in cross-border investment and business activities, the question arises regarding the right level of economic substance. Substance requirements may exist for different reasons, may be more or less clear, and need to be determined case by case. This article analyzes the importance of substance in an international tax environment that has been reshaped by the OECD's base erosion and profit-shifting project.

The importance of substance is well known, and awareness has only increased as a result of the BEPS project. From a Luxembourg tax perspective, substance is necessary to properly manage the tax residency of companies. Luxembourg companies performing financing activities must comply with specific substance requirements set out in the Luxembourg transfer pricing circular.¹ Luxembourg companies that are

subject to the oversight of the supervisory body of the financial sector (Commission de Surveillance du Secteur Financier, or CSSF), must comply with regulatory substance requirements (especially fund management companies).

Luxembourg companies that are part of an international investment structure or are members of a multinational group may have to comply with an increased level of substance to be out of reach of antiabuse legislation provided under jurisdictional tax laws and tax treaties concluded by Luxembourg. In the EU, however, those substance requirements must be consistent with EU law as interpreted by the Court of Justice of the European Union.

Substance may also be required from a transfer pricing perspective, given that the application of the arm's-length principle relies on several concepts that are closely linked to substance. Also, the economic reality must be consistent with the fact pattern described in the transfer pricing analysis. Finally, a lack of appropriate substance can be a source of reputational risk.

I. The Notion of Substance

Substance is a key element in international taxation and is relevant in the application of domestic tax law, tax treaties, and the arm's-length principle. However, substance is not a one-dimensional concept; it involves several elements that may be interrelated.

One element is infrastructure, which includes employees, office premises and facilities, and equipment. A website, email addresses, and business cards can also show substance. Luxembourg companies might rely on their own staff and directors or outsource some functions to qualified Luxembourg service providers (for example, accounting, tax compliance, and legal services).

¹Circular L.I.R. No. 56/1-56-bis/1 of December 27, 2016.

Another element of substance is corporate governance, which involves the composition of the board of directors, the organization of board meetings in Luxembourg, the involvement of qualified Luxembourg directors in the decision-making process, and the proper documentation thereof (for example, in the board minutes, emails, and internal memoranda). Furthermore, good corporate governance requires contractual aspects to be defined in robust legal documentation.

The functional and risk profile of Luxembourg companies may vary from one company to another. Luxembourg companies generally perform various functions and bear different kinds of risk for their investment and business activities. Typical functions include monitoring and managing investments, investment-related cash flows, and risks; analyzing investment opportunities; drafting or reviewing legal documentation; maintaining books and records; and preparing financial reports and tax returns.

Moreover, Luxembourg companies often render administrative and other services to group companies, carry on treasury functions, or manage intangible property rights. When some functions are outsourced to qualified Luxembourg service providers or other group companies, the directors or staff of the Luxembourg company must carefully monitor their execution. The functions performed and risks assumed by Luxembourg companies for material intragroup transactions should be analyzed in sound transfer pricing documentation when the arm's-length pricing is determined.

The last element of substance concerns commercial and legal reasons for establishing business activities in Luxembourg. It involves location features, such as a flexible and diverse legal and regulatory environment, the availability of a qualified and multilingual workforce, an investor-friendly business environment, the existing investment fund industry, and political and financial stability. It also involves individual aspects, such as existing business relationships; the familiarity of investors and lenders with Luxembourg; experience with the Luxembourg legal and regulatory system; and, potentially, existing substance.

Figure 1 depicts the different dimensions of substance.

II. Luxembourg Requirements

A. Managing Tax Residency

From a Luxembourg tax perspective, a company is considered tax resident if its statutory seat or its central administration — that is, its place of effective management — is in Luxembourg.²

A key risk requiring careful management is that a Luxembourg company is considered tax resident in another country by virtue of the effective management being exercised in that country's territory. For dual residency, tax treaties concluded by Luxembourg provide that the state of residence for tax purposes will be in the country where the company is effectively managed — that is, the tie-breaker rule.³

It is therefore critical that all important strategic and commercial decisions that are necessary to conduct the company's business occur in Luxembourg. Accordingly, the board meetings of a Luxembourg company should be regularly held in Luxembourg with the physical presence of all appointed directors.⁴ The frequency of the board meetings should be consistent with the level of activities performed by the Luxembourg company.

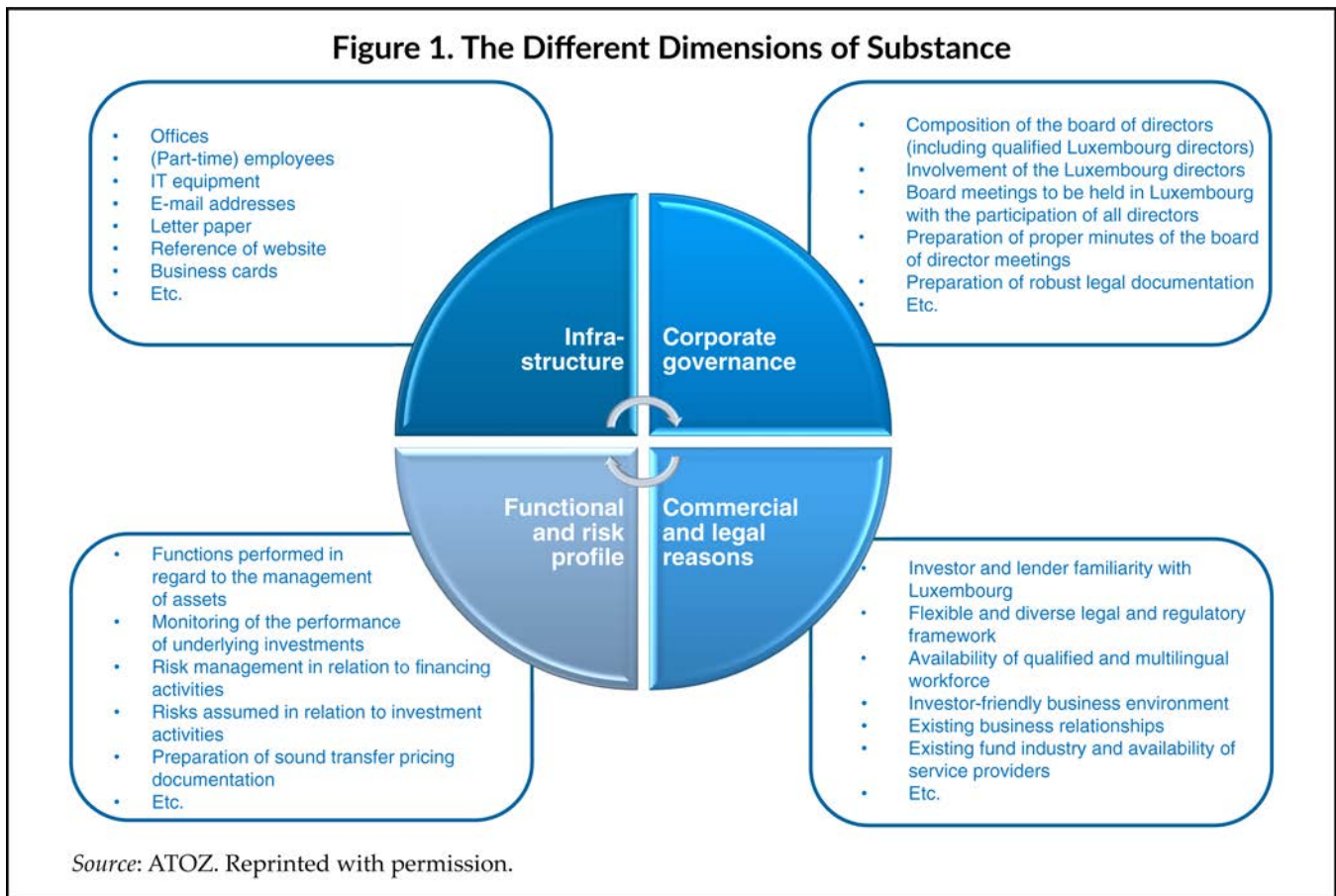
The board of directors should be (partly) composed of qualified Luxembourg resident directors who are able to exercise a management function, which should be reflected in the documentation of business transactions. While nonresidents can make strategic recommendations to the board, the directors must independently appraise each proposal, not merely rubber-stamp them. The board meetings should be properly documented in meeting minutes.

² Article 159 of the Luxembourg Income Tax Law (LITL).

³ The country where a company's effective management is located should be considered the state of residence (which may tax all the income realized by a company), whereas the other contracting state may exercise tax rights only over income sourced in its territory (if it has a right to tax under the tax treaty).

⁴ Any non-Luxembourg resident members meeting abroad to take or implement decisions without the involvement of the Luxembourg resident directors should be avoided.

Figure 1. The Different Dimensions of Substance



A Luxembourg company should have a Luxembourg bank account, and its books and records should be kept in Luxembourg. Equipping a Luxembourg company with facilities and (part-time) employees should be appropriate for the business activities performed and should be determined case by case.⁵ Alternatively, a Luxembourg company may rely on a model in which specific functions are outsourced to qualified service providers and supervised by the company's directors or employees.

B. Luxembourg Finance Companies

Luxembourg companies performing intragroup financing activities have to comply with an elevated substance standard. According

to the transfer pricing circular, Luxembourg finance companies must have a real presence in Luxembourg.

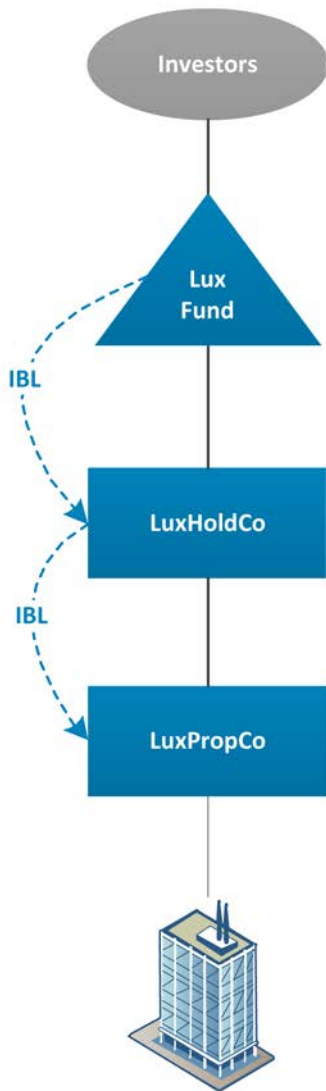
Consider an example. A Luxembourg fund (LuxFund) invests via a Luxembourg company (LuxHoldCo) in foreign real estate assets that are held via a Luxembourg property company (LuxPropCo).

LuxPropCo is financed by a mixture of debt and equity provided by LuxHoldCo. The interest-bearing loan granted by LuxHoldCo to LuxPropCo is financed by an interest-bearing loan granted by LuxFund to LuxHoldCo. Thus, under the circular, LuxHoldCo is performing financing activities. It must realize an arm's-length remuneration that should be substantiated in transfer pricing documentation. (See Figure 2.)

A company will be considered to have sufficient substance in Luxembourg if the following requirements are satisfied:

- Most of the board members with decision-making authority are either Luxembourg residents or nonresidents with professional

⁵The substance of a pure holding company, for instance, cannot be assessed in the same way as the substance of a company that is conducting active and operational business activities.

Figure 2. The Luxembourg Finance Company

Source: ATOZ. Reprinted with permission.

activity⁶ in Luxembourg.⁷ At least 50 percent of the nonresident's income from professional activities must be taxable in Luxembourg. If a legal entity sits on the board, it must have its statutory seat and

⁶The income from the professional activity must fall under the scope of the income categories in LITL article 10, nos. 1-4.

⁷Considering the wording of the circular, it appears that the number of Luxembourg resident directors (or directors realizing more than 50 percent of their income in Luxembourg) must exceed that of nonresident directors by at least one. However, in practice, this requirement is deemed satisfied if at least 50 percent of the directors are (professionally) resident in Luxembourg.

central administration in Luxembourg to be considered a Luxembourg resident.

- The members of the board of directors must have sufficient professional knowledge to exercise their functions.
- The directors must have at least the capacity to act on behalf of the company and ensure the proper execution of all transactions. Hence, Luxembourg resident board members may not act as mere nominee directors; rather, they must have decision-making powers that should go beyond administrative management of the company's activities.⁸ The full involvement of nonlocal board members is permitted, however.
- The company should have qualified personnel (or directors taking over those functions) capable of executing and registering the transactions performed, which the circular states may be the company's own employees or outside staff. Thus, the day-to-day management of the company may still be outsourced to well-established Luxembourg service providers,⁹ as long as the local directors have sufficient professional expertise and the decision-making powers of the local directors are not limited.¹⁰ Further, the company must be capable of supervising the work performed by service providers.
- The key decisions regarding the management of the company must be taken in Luxembourg. This is a particularly important requirement and suggests that board meetings in which important management decisions are taken should regularly be held in Luxembourg.¹¹ While it is possible to prepare for some board

⁸The duties of the Luxembourg resident directors should, for instance, include the settlement of transactions from a legal point of view, the management of loans, and the proper implementation of these transactions.

⁹However, the outsourced functions should not have a major effect on the control of the risk in relation to the financing activities.

¹⁰Arrangements that require the involvement of several or specific directors to take important decisions would not compromise the decision-making capacity of Luxembourg directors.

¹¹In exceptional cases, it may be acceptable for directors to participate via telephone or video conference. If the company's substance in Luxembourg is unclear, relevant documentation such as the flight tickets and hotel receipts of the directors should be collected.

decisions outside Luxembourg, local board members should be sufficiently involved in the process, and the board should not merely be a formality to confirm decisions already taken in other jurisdictions.¹²

Instead, the board members must be sufficiently involved in the transactions and the management thereof — that is, the consent of at least one Luxembourg resident director should always be required.

- Entities required by company law¹³ to hold shareholder meetings must hold at least one annual meeting at the place indicated in the articles of incorporation.
- The entity must not be considered tax resident in another state.
- Luxembourg finance companies must have decision-making power when it comes to entering into risk-bearing financing transactions and handling related risks, as well as the financial capacity to assume any risks should they materialize. They must also be financed with an amount of equity sufficient to cover the expected loss of the financing activities.

Given that the risks are generally not contractually limited, it is crucial for the directors of a finance company to carefully monitor and manage the transactional risks. An appropriate risk management policy should be developed that defines the process of risk management as well as the roles and responsibilities of the people involved.

Although the circular provides for the described substance requirements, taxpayers still have some leeway in organizing their affairs in Luxembourg through their own resources or qualified Luxembourg service providers.

C. Regulatory Requirements

Substance requirements may also derive from the Luxembourg regulatory regime. Luxembourg-based investment fund managers¹⁴

are subject to supervision by the CSSF and must comply with the substance requirements in Circular 18/698.¹⁵

The circular provides guidance on the required level of local substance and on how the core business activities and internal controls functions should be organized, including the conditions for delegating activities and the proportional application of the rules. For substance, emphasis is placed on the need for appropriate human resources to be available to an investment fund manager, based on the volume and nature of its activities.

Circular 18/698 specifies the number of conducting officers and employees required by investment fund managers, as well as the number of mandates that directors and conducting officers are authorized to have.¹⁶ It affects not only investment fund managers but also board members of investment fund managers, undertakings for collective investment in transferable securities, alternative investment funds, and related Luxembourg companies.

III. Foreign Tax Requirements

A. Antiabuse Legislation

Many countries have adopted antiabuse rules ranging from general rules to those that target specific abuses. They generally subject the recognition of foreign companies or the granting of tax benefits to the fulfillment of substance requirements.

For example, many EU member states implemented anti-directive-shopping or anti-treaty-shopping rules under which a foreign company can claim a reduced or zero withholding tax rate on dividends, interest, and royalty payments in accordance with the parent-subsidiary directive (2011/96/EU), the interest and royalty directive (2003/49/EC), or tax treaties only if the recipient of the income fulfills substance requirements. In many cases, that legislation uses

¹²When decisions prepared outside Luxembourg are merely formalized in Luxembourg, this requirement is not fulfilled.

¹³Law of August 10, 1915, on commercial companies (as amended).

¹⁴Managers of undertakings for collective investment in transferable securities (UCITS) and alternative investment fund (AIFs), including self-managed UCITS/AIFs.

¹⁵Circular 18/698, released August 23, 2018, replaced Circular 12/546, which laid down the CSSF's expectations for UCITS managers (although it also served as the benchmark for AIF managers).

¹⁶Directors are in principle limited to 20 mandates and 1,920 professional hours. There is some flexibility, including for mandates on special purpose vehicles held by the funds and for mandates in the same family of funds.

the concept of beneficial ownership, which specifies that reduced or zero withholding rates are available only if the recipient of the income is the beneficial owner thereof.

The involvement of foreign companies may further be challenged under general antiabuse rules if the tax authorities can show that an investment is merely tax-driven or the choice of legal instruments is an abuse of law. The EU anti-tax-avoidance directive (ATAD, 2016/1164) required EU states to implement a GAAR by January 1, 2019. According to the ATAD GAAR, non-genuine arrangements or a series of non-genuine arrangements put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law will be disregarded. Arrangements are considered non-genuine if they are not put into place for valid commercial reasons that reflect economic reality.

Substance might also be needed when applying controlled foreign company rules meant to limit the use of subsidiaries established in low-tax territories (so-called base companies) to reduce (or at least defer) taxation in the parent's state of residence by shifting income to a base company. Many countries have adopted CFC rules to attribute to a parent, under specific conditions, income realized by low-taxed foreign subsidiaries, irrespective of whether the base company distributes those profits.¹⁷ The ATAD also includes CFC rules that EU members had to implement by January 1, 2019.¹⁸

B. Considerations for Appropriate Substance

If Luxembourg companies may be targeted by foreign antiabuse legislation, it is crucial to determine and implement an appropriate level of substance to mitigate tax risks. However, there is no one-size-fits-all approach. Instead, the right level of substance must be tailored to individual cases.

There are several factors to consider when determining an appropriate level of substance, such as:

- *The type of investment or business activities.* While some activities require significant substance, other activities may be managed with limited substance.
- *The magnitude of the activities.* The need for substance also depends on the number of transactions and the related risks.
- *The items of income that will be realized.* In a cross-border context, foreign jurisdictions generally adopt antiabuse legislation for situations in which a nonresident company benefits from a tax advantage (for example, a reduced or zero withholding tax rate). In the absence of a tax advantage, there should be no excessive substance requirements from a foreign tax perspective.
- *The jurisdictions involved.* While some tax authorities are more demanding when it comes to substance, others have more relaxed expectations.
- *The investment strategy pursued.* When the investment strategy relies on the realization of items of income that are not subject to foreign taxation (for example, interest income and capital gains), there should be no excessive substance requirements from a foreign tax perspective.

As a rule of thumb, the substance of a Luxembourg company should be appropriate for the management of the business activities it performs. It follows that as a tendency, the more activities a Luxembourg company performs and the higher the amounts at stake, the more substance the company generally should have. However, the proper management of assets such as participations, loans, and intangibles may be managed with limited substance.

In practice, there are different ways to organize the substance of a Luxembourg company, ranging from cases with significant resources that manage most of the tasks internally to cases that outsource for cost-efficiency purposes some functions to qualified service providers (or other group companies) that are monitored by the company's employees or directors.

When substance is organized internally, asset managers and multinationals may have important substance in a master holding, management, or service company that renders

¹⁷ See Oliver R. Hoor, *The OECD Model Tax Convention — A Comprehensive Technical Analysis* 74 (2015).

¹⁸ The ATAD provided several implementation options, so the CFC rules adopted by EU states vary.

services to other Luxembourg companies. While the charging of services to the Luxembourg beneficiaries may be a good indication of the activities performed by those entities, the tax authorities of some investment jurisdictions may strongly prefer finding salary costs in the financial statements of the entities that rely on benefits provided under their domestic laws or tax treaties. In those circumstances, global employment contracts that split salary costs among group companies benefiting from the employees' work may be considered. Also, other costs such as rental costs may be split among Luxembourg companies in accordance with appropriate allocation keys.

C. EU Substance Requirements

Antiabuse legislation implemented under foreign tax law may require Luxembourg companies to have significant substance. However, antiabuse legislation adopted by EU states must comply with EU law as interpreted by the CJEU.

The CJEU has had to decide numerous cases involving the application of antiabuse legislation. One major decision was *Cadbury Schweppes PLC and CSO Ltd. v. Commissioners of Inland Revenue*, C-196/04 (CJEU 2006), which firmly established the "wholly artificial arrangement" doctrine, limiting the scope of antiabuse legislation in an EU context. In three landmark cases, the CJEU reemphasized that doctrine.¹⁹

In its decisions, the Court analyzed the compatibility of antiabuse legislation with the parent-subsidiary directive and the freedom of establishment. According to the CJEU, the objective of combating tax evasion and avoidance, whether it relies on article 1(2) of the parent-subsidiary directive or is a justification for an exception to primary law — that is, the freedom of establishment — has the same scope. Therefore,

antiabuse provisions must be targeted measures aimed specifically at wholly artificial arrangements that do not reflect economic reality and are meant to unduly obtain a tax advantage.

Thus, tax authorities should not lightly consider the presence of fraud or abuse. Moreover, taxpayers may rely on their EU freedoms when structuring investments and may jurisdiction shop, even if the choice of the jurisdiction is principally based on tax considerations.

It is, however, undisputed that member states may protect their tax bases by way of antiabuse rules that are exclusively directed at wholly artificial arrangements. Even so, when assessing the existence of fraud and abuse, tax authorities cannot rely on predetermined general criteria but must instead examine the entire operation at issue.

An abusive situation does not depend only on the intention of the taxpayer to obtain tax benefits (a motive test). It also requires the existence (or absence) of objective factors, including an actual establishment in the host state and the performance of a genuine economic activity. For the existence of an actual establishment, the CJEU does not seem to require an extensive level of substance. Again, the substance should be appropriate for the activities the company performs.

The notion of genuine economic activity should be understood broadly. It may include the mere exploitation of assets such as shareholdings, receivables, and intangibles for deriving passive income. The nature of the activity should not be compromised if that income is principally sourced outside the entity's host state.

Further, no specific ties or connections between the economic activity assigned to the foreign entity and its host state can be required by domestic antiabuse provisions. Therefore, insofar as the EU internal market is concerned, the mere fact that an intermediary company is active in conducting the functions and assets allocated to it (rather than being a mere letterbox company) should suffice to remove it from the scope of domestic antiabuse legislation.

When analyzing the substance of a company, it is necessary to analyze the situation of both the entity and the group. It might even suffice if a

¹⁹ *Deister Holding and Juhler Holding*, joined cases C-504/16 and C-613/16 (CJEU 2017); *GS v. Bundeszentralamt für Steuern*, C-440/17 (CJEU 2018); and *Egiom SAS, previously Holcim France SAS, and Enka SA v. France*, C-6/16 (CJEU 2017). National courts have not deviated from the wholly artificial arrangement doctrine laid down by the CJEU.

company relies on the staff and premises of other group companies in the same jurisdiction.²⁰

Antiabuse legislation should also not establish an irrebuttable presumption of fraud or abuse. Instead, the taxpayer must be able to provide evidence of the appropriateness of the structure.

The imposition of a general tax measure automatically excluding specific categories of taxable persons from the tax advantage without the tax authorities having to provide even prima facie evidence goes beyond what is necessary to prevent fraud and abuse. Accordingly, as long as the foreign company has appropriate substance, the nature (corporates versus individuals), origin, or tax status of its shareholders should be irrelevant for the application of antiabuse legislation.

From a practical perspective, however, setting up holding and finance companies with an artificially high level of equipment, facilities, and employees would be somewhat contrary to their economic nature. The simple presence of a manager monitoring the holding and finance activities of a Luxembourg company may in some cases be sufficient to bring substance to the structure and thus prevent it from being (partially) disregarded as a result of the application of foreign antiabuse provisions. A low level of substance is the direct consequence of the specific purpose of a pure holding and finance vehicle and should be accepted for tax purposes, according to the CJEU. It is interesting to note that up until now, national courts have not deviated from the “wholly artificially arrangement” doctrine laid down by the CJEU.

IV. Tax Treaty Requirements

A. The Principal Purposes Test

Under the principal purposes test (PPT), tax treaty benefits are denied when it is reasonable to conclude that obtaining them was one of the principal purposes of an arrangement or

transaction, unless the taxpayer can establish that granting the benefit would be in accordance with the object and purpose of the relevant treaty provisions.

The PPT was developed as part of the OECD’s work on action 6 of the BEPS project, which targeted perceived abuses of tax treaties. It is included in article 29(9) of the 2017 version of the OECD model and is part of the minimum standard of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, which resulted from the OECD’s work on action 15.²¹

According to OECD guidance, the PPT requires analyzing all facts and circumstances of each case to determine whether obtaining the benefit was a principal consideration and would have justified entering into an arrangement or a transaction that resulted in the benefit. Thus, tax authorities should not automatically conclude that a principal purpose was to obtain treaty benefits.

The OECD model commentary states that its examples are purely illustrative and should not be interpreted as providing conditions or requirements that similar transactions must meet to avoid the application of the PPT. Therefore, it cannot be said that the PPT should apply if a particular aspect in the examples is missing. Instead, whether one of the principal purposes of an arrangement or a transaction was to obtain treaty benefits must be determined case by case.

The relevant reasons and circumstances for conducting investments via Luxembourg companies can vary significantly from one case to another, so taxpayers should establish their reasons in preparation for potential questions from foreign tax authorities.

For cross-border investment activities, three examples in the OECD model commentary are of particular relevance when it comes to analyzing alternative investments such as private equity and

²⁰ In reaction to the CJEU’s judgment in *Deister Holding and Juhler Holding*, on April 4, 2018, the German Ministry of Finance released a circular in which it clarified that the provision stating that only the substance at the level of the direct parent is to be considered is no longer applicable. Hence, the substance of the entire group in the parent’s jurisdiction must be taken into consideration when assessing potential cases of abuse.

²¹ Luxembourg is a signatory to the MLI and thus will apply the PPT in its covered treaties. Depending on the speed of ratification by treaty partners, the PPT will likely become effective starting from 2020 in those treaties. See Hoor and Keith O’Donnell, “Luxembourg: Impact of the PPT on Alternative Investments,” *Tax Planning International* 2 (Jan. 2018).

real estate.²² They concern an investment platform, a securitization transaction, and a real estate fund involving different jurisdictions. All three conclude that it would be unreasonable to deny treaty benefits unless different facts and circumstances suggest otherwise. Thus, for international investments, the OECD guidance seems to suggest a high threshold for the PPT to apply.

For tax treaties concluded between two EU member states, the interpretation and application of the PPT is subject to the limitations determined by the CJEU. Hence, the PPT should apply only if it the tax authorities of the other jurisdiction can show that the Luxembourg company claiming tax treaty benefits is a wholly artificial arrangement.²³

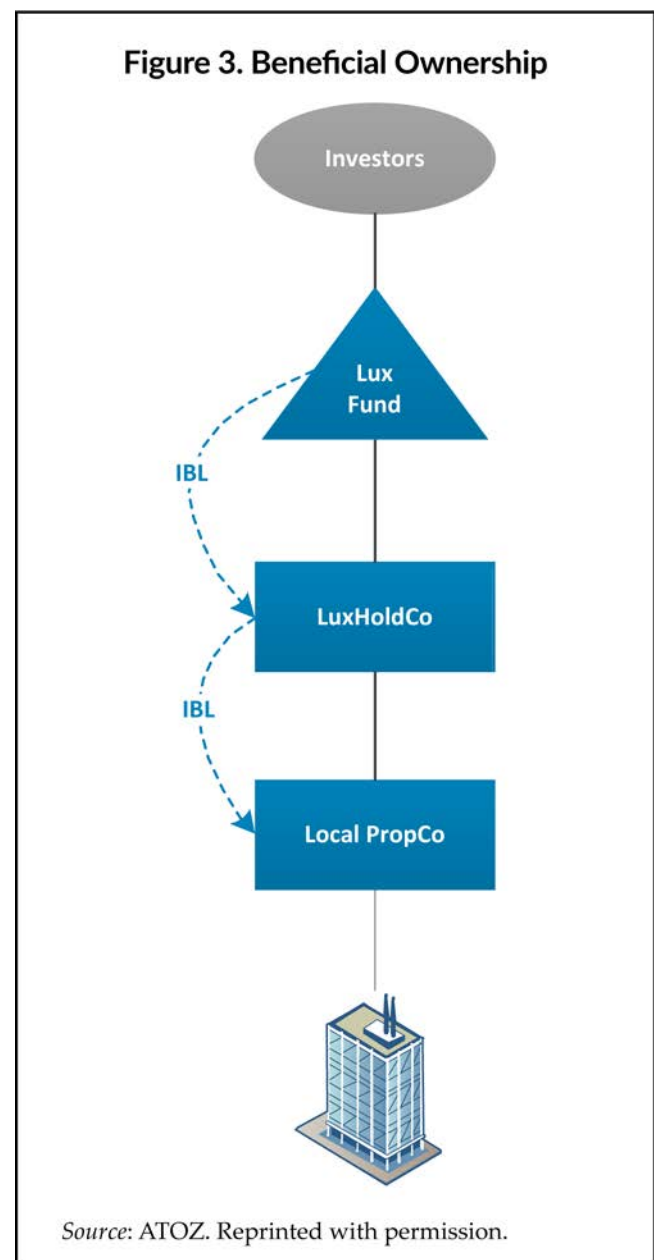
B. Beneficial Ownership

The notion of beneficial ownership plays a prominent role in tax treaties. In essence, the concept is an antiabuse rule designed to prevent treaty shopping by agents, nominees, or conduit companies for the benefit of a resident of a third state for income received from dividends, interest, and royalties.²⁴

More precisely, the OECD model states that when dividends, interest, or royalties derived from a contracting state are paid to a resident of the other contracting state, the source state's tax right is generally restricted to a percentage of the gross amount or even excluded (royalties, for example). However, tax treaties typically stipulate that the person claiming the treaty benefits must be the beneficial owner of the dividends, interest, or royalties. Thus, the source state is not bound to grant the benefits of model articles 10(2), 11(2), and 12(1) solely because the income is received by a resident of the other contracting state. Instead, the recipient must be the beneficial owner of that income.²⁵

Consider an example. A Luxembourg fund (LuxFund) invests in real estate assets in different jurisdictions via a Luxembourg company (LuxHoldCo). One of the assets is acquired via a local property company (Local PropCo) that is financed by a mixture of debt and equity.

Interest paid by Local PropCo to LuxHoldCo is in principle subject to 20 percent withholding tax under the laws of the investment jurisdiction. However, the applicable tax treaty provides a zero withholding rate if the beneficial owner of the interest is a company resident for tax purposes in Luxembourg. (See Figure 3.)



²² Examples K, L, and M regarding article 29(9).

²³ See Section III.C of this article, *supra*. Based on *Eqiom SAS*, one can guess how the CJEU will likely decide when it comes to the interpretation of the PPT in tax treaties concluded between EU states.

²⁴ Hoer, *supra* note 17, at 73.

²⁵ *Id.* See also Philip Baker, *Double Taxation Conventions and International Tax Law — A Manual on the OECD Model Tax Convention on Income and on Capital of 1992/91* (1994).

According to the OECD model commentary, the term “beneficial owner” should not be used in a narrow, technical sense, but instead should be understood in its context and in light of the object and purposes of the tax treaty, including the avoidance of double taxation and the prevention of fiscal evasion and avoidance. Consequently, it must be verified whether the recipient is liable for tax on the income. It should be irrelevant whether the income is actually taxed, and the test should be satisfied if the taxpayer is liable for tax on the income, irrespective of any applicable exemptions or available tax loss carryforwards.²⁶

The question of beneficial ownership is particularly problematic in group situations when, for example, Luxembourg companies perform financing activities, sublicensing activities, or holding activities. While it is obvious that mere legal ownership is not enough to constitute beneficial ownership, it is less clear what the connection in legal terms should be between a conduit company and a stream of income. Conduit companies are, however, usually more than mere legal owners, and — at least at first glance — they usually have full power over the underlying asset that produces the dividends, interest, or royalties. Consequently, the decision whether companies are the beneficial owners of the income they receive is not straightforward and requires case-by-case analysis.

For dividend income, a parent company should generally be considered the beneficial owner if it has no legal obligation to pass on the income to a third party. Ideally, the legal documentation states that the company may freely enjoy the dividend income and that the payment of interest or other payments under debt instruments financing the participation should be subject to the approval of the board of directors. Moreover, the parent should keep the cash in its bank account until the directors decide how to use it.

In general, a company that performs financing activities should be considered the beneficial owner of the interest income if it meets the following conditions:

- it bears the credit risk in relation to the financing activities;
- it realizes an arm’s-length remuneration for the functions performed and the risks assumed, so the amount of interest income should exceed the amount of interest expenses;
- it must cover the costs incurred in relation to the financing activities; and
- it has no legal obligation to pass on the interest income to a third party.

From a commercial perspective, it might also make sense to avoid negotiating identical terms with the lenders and borrowers. From a practical perspective, the finance company might want to keep the funds in its account for a while. Even so, it should be careful not to incur too much interest expense because it might otherwise be difficult to cover the costs and realize an arm’s-length profit.

C. Limitation on Benefits Provisions

Another antiabuse provision that has been adopted by some countries (in particular, the United States) is the limitation on benefits provision (the Luxembourg-U.S. tax treaty includes one). LOB provisions deny treaty benefits to a legal entity by default and are designed to prevent a company from accessing tax treaties if it is owned or financed abroad or if its shares are traded on a foreign stock exchange.

In other words, it will no longer be sufficient to be a resident of a contracting state to benefit from treaty protection. Instead, treaty benefits will apply only when a resident of a contracting state is classified as a qualified person under the LOB provision. Thus, a company that is a resident of a contracting state must satisfy at least one of the LOB tests to be eligible for treaty benefits. That reverses the general principle that companies should be able to enjoy the benefits of tax treaties concluded by their states of residence if they perform genuine economic activities.

While the LOB is generally not in tax treaties concluded between EU members, like any other antiabuse provision it would need to be applied in accordance with EU law as interpreted by the CJEU. Therefore, the formalistic tests of the LOB should be ineffective in the EU if a company has appropriate substance and cannot be classified as a wholly artificial arrangement.

²⁶When agents, nominees, or conduit companies are not treated as the owner of the income for tax purposes in their residence state, no double taxation should arise for that item of income.

D. Avoiding Unintentional PEs

Whenever Luxembourg companies are investing or performing business activities abroad, it is crucial to carefully manage all activities taking place in the other jurisdictions. More precisely, Luxembourg companies must avoid the constitution of unintentional permanent establishments that otherwise would create significant administrative burden and give rise to tax risks.

The main purpose of the PE concept under Luxembourg's tax treaties is to determine a contracting state's right to tax the profits of an enterprise that is resident in the other contracting state. That is because OECD model article 7 states that a contracting state cannot tax business profits of enterprises resident in the other contracting state unless it carries on its business through a PE there. In contrast, when a PE is in a contracting state, the income attributable to it may be taxed in the host state.

Model article 5 describes two types of PEs. The first is part of the same enterprise and under common ownership and control. The second is an agent that is legally separate from the enterprise but still depends on the enterprise to the point of forming a PE.

Article 5(1) defines a PE as a "fixed place of business through which the business of an enterprise is wholly or partly carried on." 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 used exclusively for that purpose. They may be owned, rented, or otherwise at the disposal of the enterprise and may even be situated in the business facilities of another enterprise.

Importantly, no formal legal right to use a place is required, but the mere presence of an enterprise at a particular location does not necessarily mean the location is at the disposal of the enterprise. The "material presence" requirement will be met when the use of the place is so extensive that it goes beyond mere presence, regardless of the form of authorization allowing the use itself. Mere presence is therefore the threshold to be considered; once it is met, the location is considered as being at the enterprise's disposal.

According to the definition of a PE, the place of business must be fixed, so it follows that the place of business must be linked to a geographical point. Since a PE generally exists only if the place of business has some degree of permanency, a temporary place of business should not constitute a PE. However, interruption of activities do not cause a PE to cease to exist if the operations are carried out regularly. For recurrent activities, the periods when the place is used must be considered in combination.

The business of an enterprise is carried out mainly by the entrepreneur or personnel, including employees and other persons receiving instructions from the enterprise. The powers those personnel have in relationships with third parties are irrelevant.

Therefore, when the directors or employees of a Luxembourg company are frequently present in foreign jurisdictions in their capacities as directors or employees of the Luxembourg company, the company should determine how to avoid creating a presence in another jurisdiction that could give rise to a PE if that is not part of the business strategy.

The PE definition in OECD model article 5 received much attention during the BEPS project. Action 7 was meant to develop an amended PE definition and related guidance to address the artificial avoidance of PE status.²⁷ The 2017 OECD model includes a definition of PE that reduces the threshold for the constitution of a PE. While changes to the PE definition in bilateral tax treaties could be implemented via the MLI, Luxembourg mainly adhered to the minimum standard. Hence, these changes should have no immediate effect on Luxembourg companies.

V. Transfer Pricing Requirements

A. The Arm's-Length Principle

The arm's-length principle, laid down in articles 9(1) (associated enterprises) and 7(2) (business profits) of the OECD model tax convention, requires that prices charged between affiliated companies correspond to those that

²⁷ See Hoor and O'Donnell, "BEPS Action 7: The Attempt to Artificially Create a Taxable Nexus," *Tax Notes Int'l*, June 8, 2015, p. 929.

would have been charged had the parties been unrelated. Therefore, transactions within a group of companies are compared to transactions between unrelated entities under comparable circumstances to determine acceptable transfer prices.

When the transfer pricing of intragroup transactions does not adhere to the arm's-length standard, foreign and Luxembourg tax authorities may challenge the prices and perform tax adjustments to restate arm's-length conditions.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations provide several acceptable transfer pricing methods for determining arm's-length prices. The traditional transaction methods include the comparable uncontrolled price method, the resale price method, and the cost-plus method. The transactional profit methods include the transactional net margin method and the transactional profit-split method. Although the comparable uncontrolled price method should be applied whenever possible, no single method is considered suitable for every situation. Rather, the taxpayer must select the method that provides the best estimate of an arm's-length price for a specific transaction.

All transfer pricing methods rely directly or indirectly on the comparable profit, price, or margin information of similar transactions. Tests of compliance with the arm's-length principle generally involve the comparison of related-party transactions to comparable transactions between the entity and a third party or of unrelated parties in the same market or industry.

The OECD transfer pricing guidelines state that two transactions are comparable if none of the differences between them materially affects factors under consideration (usually price or profit margin); if there are minor differences, it might be possible to use adjustments to eliminate these differences. Features that should be considered when selecting comparable transactions include the characteristics of the goods or services, the functions performed, any contractual terms, economic circumstances surrounding the transactions, and the business purpose of the transactions.

The application of the arm's-length principle is closely linked to substance, given that

numerous concepts in the OECD transfer pricing guidelines are related to substance in one way or another. For example, the functional analysis focuses on functions performed, assets used, and risks assumed, which are clearly features of substance. Moreover, the new guidance on the allocation of risks in controlled transactions requires the entity to be attributed the risk to have control over it and the financial capacity to assume the risk if it materializes. When it comes to attributing profits to PEs, OECD guidance emphasizes the importance of people functions.

Hence, the application of the arm's-length principle can be a basis of substance requirements because substance could have a direct effect on the allocation of profits. Further, for a transfer pricing analysis to hold up against challenges by tax authorities, the economic reality must be consistent with the fact pattern described in the transfer pricing documentation.

B. Supply Chain Management

Supply chain management is essentially a cross-functional approach in which several entities of an MNE manage the movement of raw materials into the organization, the processing of materials into finished goods, and the movement of finished goods to the consumer. That implies that MNEs are adopting supply chain models for managing all aspects of their business. Supply chain management allows MNEs to take advantage of economies of scale and benefit from a combination of negotiation powers.

Supply chain management is closely linked to substance, given that generally, the more functions an entity performs and the more risks it assumes and assets it uses, the more profits it would be expected to realize at arm's length. In other words, substance has an effect on the attraction of income in multinational groups.

There are several potential supply chain models that may be optimal for the MNEs' needs. However, MNEs generally implement supply chain management structures characterized by a centralization of business activities. A company in the multinational group, acting as a principal, assumes and manages most of the business risks, which implies that the operating companies at other levels (for example, manufacturing and sales) perform reduced functions and bear limited

business risks. From a transfer pricing perspective, that functional and risk profile results in a basic return, whereas the real entrepreneur — the principal company — is entitled to the residual profits.²⁸

The OECD transfer pricing guidelines acknowledge that associated enterprises might engage in transactions that independent enterprises would not undertake. Accordingly, MNEs might implement supply chain management structures to take advantage of the very fact that they are MNEs and can operate in an integrated fashion.²⁹ Chapter IX of the OECD transfer pricing guidelines provides extensive guidance on the application of the arm's-length principle to business restructurings.

Even so, because the centralization of some functions, assets, and risks in the multinational group generally results in a shift in profit potentials (in accordance with the arm's-length principle), tax authorities pay close attention to supply chain restructurings and the related tax effects. It is therefore important that after a business restructuring the new business model is sufficiently substantiated and can be upheld. The entities involved should actually perform the functions and bear the risks allocated to them — this is a matter of economic reality and not of mere contractual obligation.³⁰

When the OECD launched its BEPS project in 2013, transfer pricing — particularly the ability of MNEs to shift risks among associated enterprises — was identified as a key area of focus. The work performed under action 9 resulted in a fundamental redrafting of Chapter I, section D (guidance for applying the arm's-length principle) of the OECD transfer pricing guidelines. The basic idea behind the new guidance is to address contractual risk allocation that lacks the

commercial rationality of uncontrolled transactions.

In analyzing risk allocation between associated enterprises in a controlled transaction, the functions performed, assets used, and risks assumed by the parties are examined. Based on practical experience, the analysis of risk in relation to controlled transactions is harder than the analysis of functions and assets. Thus, the revised OECD guidelines provide a six-step approach to identify and allocate risks in controlled transactions. The new framework is intended to counter situations in which an entity earns inappropriate returns solely because it has contractually assumed risks or provided capital.

C. Transfer Pricing Documentation

Transfer pricing documentation is an important way to substantiate the arm's-length character of conditions agreed on in controlled transactions between associated enterprises. The OECD transfer pricing guidelines include a chapter on documentation, which has been revised in accordance with the final report on BEPS action 13.

The new guidance asks a multinational to prepare a master file for its global business operations and a local file for each country.³¹ It also includes a template for country-by-country reporting that requires MNEs to report their income, earnings, taxes paid and accrued, as well as specific measures of economic activity, to the tax administrations of the countries where they operate.

Luxembourg tax law does not require the preparation of transfer pricing documentation. However, taxpayers must cooperate with the Luxembourg tax authorities and provide facts and information regarding statements made in tax returns. Therefore, Luxembourg companies should screen major intragroup transactions to identify specific issues that could raise the tax authorities' suspicions and assess the magnitude of related tax risks. Based on that risk assessment,

²⁸ Because principal entities are typically resident in a relatively low-tax jurisdiction, the implementation of principal structures in normal business conditions might reduce an MNE's overall effective rate.

²⁹ Some transactions may hardly if ever be found between independent enterprises (para. 1.10 in Chapter I of the OECD guidelines). See Monique van Herksen, "Chapter 2: Business Models," in *Transfer Pricing and Business Restructurings: Streamlining All the Way* 17 (2009).

³⁰ The principal should have the right people and appropriate resources to manage the functions and risks allocated to it. See *id.* at 42; and Mario Petriccione, "Chapter 11: Supply Chain Management," in *Fundamentals of International Tax Planning* 189 (2007).

³¹ The master file includes high-level information regarding an MNE's global business operations and transfer pricing policies. The local file provides more documentation, including relevant related-party transactions, the amounts involved in those transactions, and the company's analysis of the related arm's-length character of the transfer pricing.

taxpayers should align their efforts regarding transfer pricing documentation.

Transfer pricing documentation is linked twofold to the notion of substance. First, for a transfer pricing analysis to be relevant, the fact pattern described in the transfer pricing report must be consistent with economic reality. Second, the preparation of sound transfer pricing documentation is on its own an element of substance because it reflects the activities performed. Also, a regular review of transfer pricing documentation by employees or directors further strengthens a company's functional profile.

VI. Reputational Risks

Over the last several years, corporate taxation and the way large MNEs organize their business activities have received a lot of political and media attention. That can result in reputational risks, which should be carefully managed. When deciding on the overall tax strategy of a multinational group, the reputational risks associated with a specific structure should not be overlooked.³²

While some tax measures might maximize profits in the short term, using them could also lead to a costly loss of reputation in the long run. In this era of high-speed information, even erroneous reports made at a superficial level might leave lasting impressions that could threaten brand value. Evidently, it takes a lot of time and effort to explain complex tax rules and disprove alleged tax avoidance.

To minimize reputational risks, MNEs should increase transparency in the location of their business and where taxes are paid to illustrate how their presence contributes to the economies in which they operate. Examples of those kinds of contributions include income and social security taxes from the generation of employment, VAT, business taxes, and corporate income taxes.

³² A damaged reputation could also affect the relationship with local tax authorities and their perception of a multinational group.

Multinationals further contribute to economies by consuming local goods and services, which generates additional demand and jobs. In the future, transparency may be increased by using tax reports in much the same way that corporate responsibility statements are used today.

From a risk management perspective, companies should have systems in place to ensure they are aware of any material tax and reputational risks and that their tax obligations are monitored and fulfilled. It follows that appropriate resources should be allocated to the tax function.

VII. Conclusion

Luxembourg companies are often involved in cross-border investment and business activities for which substance is an omnipresent topic. Over the last few years, countries have implemented antiabuse legislation in their domestic tax laws and bilateral tax treaties that follows the recommendations in the OECD's final BEPS reports. All that puts more emphasis on economic substance, commercial rationale, and business purpose.

In the EU, substance requirements under antiabuse legislation must be consistent with EU law as interpreted by the CJEU. Thus, taxpayers may rely on their EU freedoms when structuring investments and business activities as long as the underlying contractual arrangements are not wholly artificial arrangements. That limits the scope of antiabuse legislation to abusive situations.

Substance requirements may also be required from a transfer pricing perspective to ensure that all group companies have functional and risk profiles that are consistent with the overall strategy. Finally, reputational risks can be a source of substance requirements.

Ultimately, there is no one-size-fits-all approach to substance. Instead, the appropriate substance must be determined case by case and should be tailored to the needs of the entities involved. ■