OECD releases Multilateral Instrument to Implement Tax Treaty related BEPS Measures : What is the right approach for Luxembourg ?

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

I. Introduction

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

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

II. Overview of the Multilateral Instrument

1. Overview

The purpose of the MLI is to modify existing bilateral tax treaties, which is generally done through bilateral protocols. However, the MLI will not function as an amending protocol to an existing tax treaty, directly amending the text thereof. Instead, it will be applied alongside existing tax treaties and render the application of tax treaties a much more complicated exercise. Contracting States may nevertheless develop a consolidated version of the updated tax treaty for easy reference. The MLI enters into effect for a "covered" tax treaty once both parties to that treaty have ratified the MLI.

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

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

2. Hybrid mismatches

Articles 3 and 5 of the MLI provide for clauses that deal with hybrid mismatch arrangements (i.e. hybrid entities and instruments) that result in double non-taxation. Moreover, Article 4 provides for a provision that addresses dual resident companies, determining that in case of a dual resident company, the competent authorities of both Contracting State shall endeavor to determine, by mutual agreement, the state of residence of the company. Nevertheless, when companies are dual resident, this is generally not for tax purposes but for commercial reasons. Therefore, it would be good to keep the existing corporate tie-breaker rule according to which a company is deemed to be resident in the Contracting State in which the place of effective management is situated. The tie-breaker rule is a tried and tested concept that provides reliable results which are not depending on negotiations between tax authorities with unclear outcome.

However, all these provisions are merely optional and there is no obligation whatsoever for Luxembourg to adopt any of these (in particular, since these provisions would not make Luxembourg`s tax treaty network more attractive for international investors).

3. Tax treaty abuse

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

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

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

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

Article 9 proposes amendments to the so-called immovable property company clause (Article 13 (4) of the OECD Model Tax Convention), an anti-abuse provision provided in the OECD Model Tax Convention. While tax treaties in general allocate an exclusive taxing right over capital gains realized upon disposal of a participation to the residence state of the shareholder, Article 13 (4) of the OECD Model Tax Convention allocates an unlimited primary taxing right to the other Contracting State if the shares derived more than a certain part of their value from immovable property situated in that other Contracting State.

This Article is of wide application and can be problematic for investors in that it creates economic double taxation of gains.

According to the proposed changes in the MLI, Article 13 (4) would be applicable if the threshold (of immovable property investments) is met at any time during the 12 months preceding the alienation and equally apply in case of a sale of a comparable interest in a partnership or trust. In addition, signatories to the MLI can chose to extend the application of Article 13 (4) to all their treaties including those without such a clause, provided the other Contracting States take the same approach.

Luxembourg is a major hub for the structuring of cross-border real estate investments. Therefore, opting for this extension of would seem detrimental for investors and Luxembourg`s interest.

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

4. Avoidance of permanent establishment status

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

Article 13 provides parties with two alternative provisions that both aim at ensuring that a combination of activities that each on its own are of a preparatory or auxiliary nature, whilst on a combined basis they do exceed this threshold, would come within the scope of the PE concept.

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

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

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

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

5. Improving dispute resolution

Article 25 of the OECD Model Tax Convention provides for a mutual agreement procedure that allows the competent authorities of the Contracting States to resolve issues involving the application and interpretation of the tax treaties they have entered into. These disputes involving two jurisdictions and double taxation may be long lasting exercises for taxpayers as the tax authorities involved have, quite naturally, no incentive to easily give up their taxing rights. All the more in the current environment of chronic uncertainty, a well-functioning dispute resolution is necessary in order to protect taxpayers against arbitrary decisions of foreign tax authorities.

Part V of the MLI addresses these concerns and provides for an optional provision regarding the mutual agreement procedure and a provision regarding corresponding adjustments. The latter concerns situations where one Contracting State performs a transfer pricing adjustment and forces the other Contracting State to perform a corresponding adjustment in order to eliminate (economic) double taxation (provided that the competent authorities of both Contracting States conclude that the primary adjustment was consistent with the arm`s length principle). While these provisions are also optional and Luxembourg generally adopted such provisions in all its tax treaties, Luxembourg should opt for these provisions that can only be beneficial for Luxembourg resident companies.

6. Arbitration

Articles 18 through 26 of the MLI provides for a binding arbitration procedure which would give multinational enterprises, facing double taxation due to adjustments of their profits, a remedy that obliged the Contracting States to resolve the double taxation. Where unresolved issues have prevented competent authorities from reaching a mutual agreement within two years, the proposed rule determines that the issues which are preventing them from reaching an accord will, at the request of the taxpayer who presented the case, be solved through an arbitration process.

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

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

III. Conclusion

The MLI is a comprehensive convention that allows countries to implement a wide range of tax treaty related BEPS measures with a lot of options and alternatives (including the option not to adopt the provisions). However, the measures of the MLI will only apply to a specific tax treaty if the option/alternative pursued by a treaty party is matched by its treaty counterparty. Hence, it remains to be seen to which extent countries will align their positions in practice. Many countries have already announced not to adopt a large part of the proposed provisions, "cherry picking" the MLI. Thus, not opting for certain measures is fully legitimate and there are good reasons for Luxembourg not to implement some of the proposed changes. Likewise, Luxembourg should take the opportunity to opt for the dispute resolution and arbitration rules which can only be good for Luxembourg taxpayers. However, it is not in the interest of Luxembourg to adopt the rules on hybrid mismatches and the changes to the PE definition for treaty purposes.

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

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