ATOZ

TAX ADVISERS

LUXEMBOURG

INSIGHTS

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Taxand

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EDITORIAL

Greetings,

Taxation is undergoing a major transformation.

At a global level, the OECD is pursuing its work in developing tools to fight base erosion and profit shifting. It released recommendations on seven of the fifteen actions identified in its BEPS Action Plan.

At a Luxembourg level, the government took the opportunity of the recent 2015 draft budget law to adopt a forward looking package. This package reflects the strong will of Luxembourg to appear as a transparent and business-friendly jurisdiction aligning with OECD requirements. A legal framework for transfer pricing documentation and “ruling” practice is about to be introduced. These changes were under discussion long before the state aid procedures opened against Luxembourg for alleged aids in the form of transfer pricing agreements with Fiat and Amazon. Still, these measures seem to come just at the right time in the current context. The budgetary measures for 2015 include an increase in VAT rates, which aims to compensate the loss of revenues due to the end of the current EU e-commerce regime in 2015. VAT rates in Luxembourg will still remain the lowest within the European Union however.

On the bilateral side, Luxembourg signed the long awaited protocol to the France-Luxembourg double tax treaty. The protocol amends the rules applicable to capital gains on the sale of shares or other rights in real estate companies and will require a careful review of existing investments in French real estate so as to mitigate any potential adverse tax consequences.

Enjoy your reading.

The Atoz Editorial Team

BUDGET 2015: TAX MEASURES TO BE INTRODUCED AS OF 1 JANUARY 2015

The 2015 Budget was presented on 15 October by Finance Minister Gramegna to the Parliament.

At this occasion, the 2015 budget draft law and a draft law including a set of measures for the future (so-called *Zukunftspak*) have been released which both include some tax measures to be introduced as of 1 January 2015. The changes to be introduced mainly follow the announcements made by Prime Minister Bettel earlier this year during his speech to the Nation. They follow the current global trend for more transparency and more requirements in respect to transfer pricing documentation and anticipate some of the changes that Luxembourg will have to make in order to adapt its legislation to the OECD requirements on Base Erosion and Profit Shifting (BEPS) in this respect. The measures also include some positive changes, such as a formalisation of the advance tax clearance or "ruling" practice, which will give tax payers more legal certainty and will make the whole process more effective.

Advanced tax clearances (*décisions anticipées*) – current practice to be formalised

The draft law introduces amendments to the General Tax Law and sets down a legal framework for advanced tax clearances (ATC). The provisions to be introduced will allow taxpayers to file an ATC request with the tax authorities. The request has to be filed in written form and has to be duly motivated. The draft law explicitly states that the decision subsequently issued by the tax authorities will have a binding effect on the tax authorities, provided however that the taxpayer performs his transactions in line with the description made in his request.

Even though it remains to be seen how the Grand-Ducal decree to be released will clarify the details of the procedure, this change is welcome and can be considered as good news for tax payers as it will give more legal certainty to ATCs and should also improve their process.

Minimum Corporate Income Tax rules to be amended

Based on the rules currently in force, Luxembourg companies are subject to a minimum amount of Corporate Income Tax (CIT), which varies depending on the activity they perform:

They are either subject to:

- a minimum CIT of EUR 3.210 (including a 7% solidarity surcharge) to the extent that more than 90% of their assets are financial assets, transferable securities, bank deposits and receivables against related parties, OR, if they do not fall within this first category
- a minimum CIT which ranges between EUR 535 and EUR 21.400 (including a 7% solidarity surcharge) depending on the level of the total balance sheet of the Company.

In practice, based on the rules currently applicable, newly incorporated companies which have not started their activities and have only cash in their balance sheet are subject to the minimum CIT of EUR 3.210.

This minimum CIT might be higher than the one applicable to companies holding other types of assets, as the minimum CIT for these companies may amount to EUR 535 for example. Also, based on the current provisions, certain companies holding financial assets but which have not exceeded and will not exceed a certain size are subject to the EUR 3.210 minimum CIT.

In order to protect companies which have been incorporated recently and are developing their activities or which qualify as small or medium size companies, it is planned to amend the minimum CIT rules to exclude from the scope of the EUR 3.210 minimum CIT small and medium size enterprises, which are defined by the draft law as companies the total balance sheet of which does not exceed EUR 350.000.

This means that in the future the minimum CIT of EUR 3.210 will only apply if 2 cumulative conditions are met:

- Minimum of 90% of financial assets and
- Total balance sheet higher than EUR 350.000.

If these 2 cumulative conditions are not met, companies will pay a minimum tax which will vary depending on the level of their balance sheet.

Transfer pricing rules to be amended

The government proposes to amend the transfer pricing provisions included in the Luxembourg Income Tax Law. Currently, the tax authorities may determine the taxable income of Luxembourg tax payers in case of a transfer of profit due to a special economic relationship with a non-resident taxpayer. The new provisions will allow tax authorities to make adjustments to the taxable base if it appears that the price charged by the taxpayer differs from the prices that would have been applied between independent enterprises for comparable transactions.

The following situations are targeted:

(a) an enterprise that takes part, directly or indirectly in the management, control or capital of another enterprise, or

(b) the same persons take part directly or indirectly in the management, control or capital of two enterprises,

AND for (a) or (b) both enterprises are engaged in commercial or financial transactions the conditions of which differ from the ones which would apply between independent enterprises.

A Grand-Ducal decree will be issued to give details as to the application of the new provisions.

In its commentaries, the Government has already given some guidance and explains that the main features to be taken into account to perform the comparability analysis are the characteristics of the property or services/goods transferred, the functions performed by the involved parties, the provisions of contractual agreements, economic circumstances and commercial and industrial strategies pursued by the parties. The Government explicitly states that OECD guidelines apply to both the taxpayers and the tax authorities.

Transfer pricing documentation requirements

The draft law suggests amendments to General Tax Law so as to introduce additional documentation requirements. The article of the law to be amended deals with the supporting documentation which tax payers have to provide to the tax authorities upon request in order for these authorities to be able to determine the tax due.

A new provision is to be introduced in the General Tax Law which explicitly extends the general obligation of information and documentation to transactions involving associated enterprises.

In the commentaries to the draft law, the government clearly explained that the purpose of this new provision is to clarify that the documentation requirements of the General Tax Law apply to transfer pricing matters and to impose on taxpayers an obligation to document transactions between associated enterprises. In case circumstances would reveal the probable existence of an undue shifting of profits, and if these circumstances are not documented by the taxpayers, the tax authorities are allowed to recognise this undue shifting of profits without being obliged to prove it with detailed evidence.

However, the draft law does not expand on the exact contents of the required TP documentation. Indeed, according to the government, the exact nature of the documentation depends on the individual circumstances of the case.

WHT on dividends – Change to bring Luxembourg rules in line with EU Law

The draft law amends the Luxembourg Income Tax Law in order to bring Luxembourg legislation in line with EU law as far as dividend withholding tax is concerned.

The EU Commission considered recently that the Luxembourg legislation was not in line with EU law, given that only Luxembourg residents could be reimbursed the part of the tax withheld at source which exceeded the tax finally due, while for non-residents, the withholding tax was final.

In the future, reimbursements of dividend withholding tax will no longer be possible (neither for residents, not for non-residents), except in case of a reimbursement of withholding tax if the conditions of participation exemption regime are met.

Taxation of individuals: 0,5% contribution introduced

A 0,5% contribution will be introduced as of 1 January 2015 for individuals.

The contribution will apply to the gross professional income (salaries, directors' fees, professional fees), to income from patrimonial assets and to pensions, whereby the taxable income (as far as salaries are concerned and under certain conditions) will be reduced by an amount equal to 1/4 of the minimum salary.

This means that the 0,5% taxable basis will be reduced by an amount of EUR 480 per month.

Applied to a monthly gross salary of EUR 5.000, the amount of the contribution would be as follows:
(5.000 - 480) * 0,5% = 22,60 EUR

Additional contribution for "rich" municipalities

Municipalities deriving an amount of municipal business tax (MBT) which substantially exceeds the national average of MBT will have to pay an additional contribution to the unemployment fund.

The details of the computation of this additional contribution will be provided in a Grand-Ducal decree.

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VAT IMPACTS OF THE 2015 LUXEMBOURG BUDGET BILL

As part of the 2015 Budget, draft law n°6720 has been submitted to the Luxembourg Parliament on October 15, 2014. The proposed legislation aims at mitigating the loss of VAT revenues following the entry into force of the new VAT regime for e-services (as of January 1st, 2015).

Based on the draft law and on the first comment of the VAT authorities (FAQ published on the AED website), this reform involves the following modifications:

Increase of the Luxembourg VAT rates

To the exception of the super-reduced 3% VAT rate, all the VAT rates will be increased by 2% as of January 1st, 2015 (respectively from 6%, 12 % and 15% to 8 %, 14% and 17%).

In its FAQ, the VAT authorities have clearly specified that down payments paid in 2014 in relation to goods or services received from Luxembourg providers would remain subject to the 2014 VAT rates even if the delivery of the services or goods takes place after December 31, 2014.

VAT in the housing sector

Another significant measure concerns the VAT rate applicable to construction/acquisition costs in relation to dwellings not occupied by owners. Until now, the 3% VAT rate applied up to the limit of EUR 50.000,00 of tax benefit. As from January 1st, 2015, these costs will be subject to the 17% VAT rate.

As an example, acquisition costs incurred by a private individual acquiring a new building in 2014 for the purpose of leasing it to a third party using this building as primary residence will be subject to the 3% VAT rate (up to a limit of EUR 50.000,00 of tax benefit). As from January 1st, 2015, such an acquisition, not allocated to the primary residence of the owner, should in principle be subject to the 17% VAT rate.

Nevertheless, transitional measures have been proposed in order to keep the benefit of the 3% VAT rate until December 31, 2016 for acquisitions in relation to non-owner-occupied dwellings to the extent a request for the application of the 3% rate is made before January 1st, 2015. Circular letter n°771 (published on October 24, 2014) details the documents to be communicated to the Tax Office in order to request the benefit of this transitional measure.

Additional measures

Alcohol beverages consumed in restaurants will be subject to the 17% VAT rate instead of the current 3%.

The bill also introduces a new procedure in relation to late or non-reimbursement of VAT credits by the VAT authorities to taxable persons. Administrative and jurisdictional appeals are foreseen as well as the assessment of interests on arrears in case of unfounded VAT refund denial decisions.

Implications

These measures imply an additional VAT cost for private individuals, real estate investors and companies with no or limited VAT deduction right as from January 1st, 2015. Nevertheless and despite this increase, the Luxembourg standard VAT rate will remain the lowest within the EU member states.

We therefore urge businesses to review billing and accounting systems as well as agreements currently in force in order to reflect the rate changes.

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LUXEMBOURG SIGNS NEW PROTOCOL TO FRANCE-LUXEMBOURG TREATY

The long awaited protocol to the France Luxembourg double tax treaty (DTT) was signed on 5 September 2014. The protocol amends the rules applicable to capital gains on the sale of shares or other rights in real estate companies and allocates the right to tax these gains to the source country.

The protocol provides that capital gains derived by a resident of Luxembourg/France from the alienation of shares, units or other rights in companies, trusts or any other entities that derive directly or indirectly more than 50% of their value from real estate assets located in the other contracting state are taxable in the source country (country in which the real estate is located). In other terms, these gains are taxed in the same way as real estate income. Real estate assets allocated to the business activity of an enterprise are excluded from this clause.

So far, under the current DTT provisions, capital gains realised on the sale of shares in real estate companies were taxed at the place of the residency of the seller. In other terms, gains derived by a Luxembourg company from a French property company holding French real estate were exempt in France and only taxable in Luxembourg. In Luxembourg, they could possibly benefit from the

Luxembourg participation exemption regime. With the new provisions of the protocol, capital gains derived by a Luxembourg company from a French property company will become taxable in France.

Particular attention has to be given to the wording of this new provision. The wording goes beyond the recommendations of the OECD in its Model Tax Convention. While the latter covers only capital gains on the alienation of shares or comparable interests, the protocol covers shares as well as any other rights.

The amendment to the France-Luxembourg DTT will require a careful review of existing investment structures in French real estate so as to mitigate any potential adverse tax consequences. If both countries manage to complete the ratification procedures before year-end, the protocol will enter into force on 1 January 2015, which means that clients with real estate investment structures in France or which plan to invest in French real estate should seek advice from their tax adviser quickly.

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THE EU WATCHDOG - READY TO BITE MULTINATIONAL COMPANIES? OR HOW THE EU COMMISSION WANTS TO USE STATE AID PROCEDURES TO BECOME A SUPRANATIONAL TAX INSPECTOR

What do an automotive multinational, an e-commerce company, a multinational coffee house and a hi-tech consumer products company have in common? Fiat, Amazon, Starbucks, and Apple have been catapulted under the media spotlight and accused of not paying their “fair share of taxes”. The ever - increasing focus on these multinational companies has all the attributes of a witch-hunt. The recent opening of investigations by the EU Commission in the context of the “State Aid” legal framework adds to this appearance. On 11 June 2014, the EU Commission formally opened State Aid procedures against Ireland, Luxembourg, and the Netherlands alleging illegal State Aid to Apple, Fiat, Amazon and Starbucks. Some brief words are necessary to explain the legal framework surrounding the opening of these procedures.

What is State Aid? Why is it illegal?

The Treaty on the Functioning of the European Union (the TFEU) protects free competition within the European Union. For that purpose, it prohibits illegal State Aid. Illegal State Aid is defined and prohibited: “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the provision of certain goods shall be incompatible with the common market, in so far as it affects trade between Member States.” In broad terms, Member States are not allowed to grant selective advantages that may distort competition between Member States.

Although tax was not the primary focus of the illegal State Aid prohibition, the very broad terms of its definition include tax measures. Any reduction in a firm’s tax burden entails a corresponding reduction of tax revenue for the State. If the tax measure is selective, in other terms if it benefits a certain sector or company, the tax measure can be illegal state aid.

What is the role of the EU Commission?

It is worth recalling the functions of some of the key institutions of the European Union (EU): the Parliament, the EU Council (the “Council”), and the EU Commission (the “Commission”) and the European Court of Justice (the “ECJ”).

The Council gathers the heads of governments of the respective EU Member States. It defines the general orientations of the EU. It can request the EU Commission to forward legislation proposals to the Parliament. Directly elected by the citizens, the EU Parliament is the legislative institution. The EU Commission represents the interests of the European Union and acts as a guardian of the EU Treaty: it proposes draft laws, ensures the enforceability of the EU law (initiating infringement proceedings). As such, the EU Commission is - or at least is supposed to be- politically independent.   The ECJ is the court that settles matters of European law and has jurisdiction throughout the EU.

The TFEU makes of the Commission the competition supervisory authority. It is given the broadest powers as regards State Aid. Not only it has the power to investigate on its own initiative the existence of a potentially illegal State Aid but it has the power to decide if the aid is illegal. If it considers an aid to be illegal, it can decide that the State concerned has to abolish it and has to recover the illegal aid from the beneficiary. In practice, this means that the beneficiary has to reimburse all of the aid received from the State concerned. If the State concerned does not comply with the decision of the Commission within the prescribed time, the Commission is allowed to refer the matter to the ECJ. The State concerned is also allowed to bring the decision of the Commission to the ECJ.

An "initiative" influenced by the media?

The Commission is largely dependent on the assistance of other Member States in monitoring the correct application of EU competition law. Traditionally, complaints of other EU Member States constitute the primary source of information of the EU Commission as regards the existence of a potentially illegal State Aid. This is particularly true in tax matters where a Member State will consider that the tax measures taken by another Member States will have negative impacts on its tax competitiveness.

In the case of the multinationals concerned, nothing suggests that one Member State would have lodged an official complaint to the Commission. The Commission appears to have acted here on its own initiative, which is less frequent in tax matters. One can't help but wonder what motivated the action of the EU Commission. The multinational companies concerned became over the last two years "media friendly" targets. At a global level, a political consensus to fight "abusive" tax planning has been reached with the OECD being mandated to prepare the BEPS action plan. When the Commission starts four investigations in a row against high profile media targets, it is interesting to consider if the action of the Commission is inspired by the media as much as any objective criteria.

An institutionalised witch hunt?

From a pure legal standpoint, state aid investigations are proceedings directed at the State and not at the beneficiary of the alleged aid. That is why the investigations of the EU Commission that mention these multinationals are initiated, formally speaking, against Ireland, Luxembourg and the Netherlands respectively. To date, State Aid investigations have been almost entirely directed against specific legal provisions in a State that would favour a type of company or sector. State Aid procedures directed at specific taxpayers have been usually initiated in the context of specific measures disclosed to the EU Commission by the concerned Member State itself. The use of State aid proceedings directed at the taxation of individual taxpayers on the own initiative of the Commission is highly unusual and the repetitive use of state aid proceedings naming individual multinationals without a specific tax measure being at stake over the last few months is unprecedented.

The Commission's investigations appear to be directed against the application of transfer pricing principles by the Member States in the case of each individual taxpayer selected. The objection of the Commission is therefore not in relation to the legal system per se but its application to the case of a specific taxpayer. Thus the "selectivity", an essential condition for State aid, would seem in the Commission's eyes to be based on application of general laws to an individual taxpayer. This seems to put the Commission in the strange position of arguing that application of tax laws to an individual taxpayer, something that tax authorities have to do on a daily basis, is, per se, capable of being selective and can amount to state aid. Every assessment, every advance pricing agreement, every settlement of tax of litigation outside court thus becomes potentially suspect.

Objectively, it is hard to see why, on purely legal grounds, the Commission would ever want to pick this particular battle and direct its action to a small hi profile sample of multinationals. It is hard to avoid the conclusion that, influenced by the current media and political context, the Commission felt the need to show it was relevant in the global consensus against base erosion and profit shifting.

The reading of the letters addressed to the States concerned is particularly interesting. We will focus below on the letter addressed to Luxembourg by reason of its alleged aid to "FFT". It is interesting to note as an introductory remark that the Commission took the highly unusual step of assuming that the company described as "FFT" in an anonymised response from Luxembourg was in fact Fiat Finance and Trade Ltd S.A. and proceeded to publically open an investigation naming Fiat before it had received any official confirmation of the point. Luxembourg had refused to provide the name of the taxpayer on the grounds of confidentiality and this refusal is the subject of separate ECJ litigation. This litigation would normally have proceeded and both Luxembourg and the Commission would be bound by its findings in due course. From an administrative and legal perspective, there was no urgency to advance pending resolution of this point. That the Commission felt the need to pre-empt the finding of the ECJ and proceed to publicly name Fiat is peculiar to say the least, and adds to the impression of an action based on politics as much as on law.

A supranational tax inspector?

The Luxembourg Tax Authority "LTA" agreed on the 3rd September, 2012, an Advance Pricing Agreement (APA) with FFT. The pricings applied by FFT and agreed by Luxembourg tax authorities was documented in a detailed manner and justified by reference to the OECD principles. The letter of the EU Commission that reviews the details of the Transfer Pricing (TP) methodology applied and its criticisms of the methodology is about 30 pages long. We are far from the cliché of the multinational company that applies a discretionary pricing with the overt or covert blessing of passive tax authorities. The multinational company had a detailed transfer pricing analysis performed by its advisers, documented and justified by reference to OECD principles. The EU Commission itself admits that the methods explained in the OECD principles can give a wide range of taxable bases. The EU Commission "has some doubts" about the method applied. The whole letter is about the doubts the EU Commission has about the methods employed, about what would have seemed the best for the LTA to do. The doubts expressed are highly technical, covering appropriate comparable enterprises and sectors, how to apply Basel II principles by analogy in non-bank financing, what Beta to use in calculating target returns on equity, whether or not capital invested in shareholdings should have a separate return on equity, etc. As a TP specialist one could certainly sympathise with some of the Commissions doubts, but essentially they can all be argued in a number of ways with different results.

So what are Luxembourg/ FFT being investigated for? Applying OECD principles that don't meet the Commission's approval? The OECD and its members (including the current EU Member States) took years to define TP guidelines and the work is still in progress. TP is not an exact science - it seeks to get close to the "arm's-length" standard in a non-arm's-length context. By using proxies, such as "Comparable Uncontrolled Price", transfer pricing allows taxpayers and tax authorities to agree a price close to the arm's-length standard, but by essence it will always be an approximation. The approximation will also necessarily involve an element of subjectivity in deciding the transfer price; this subjectivity may drive the choice of certain features of the comparables being used to set a transfer price, features such as the reference period, the sample size, the reference population of companies, the reference industries, geographies, etc. This subjectivity also means that disputes between tax payers and tax authorities, or between tax authorities in different States are common.

Can a Member State be blamed for approving a documented transfer pricing method and in particular does approving a transfer pricing report presented by a taxpayer constitute State Aid in the sense that the State is "favouring certain undertakings"? The Commission, fortunately, is not of the view that any approval of a transfer pricing policy is selective and can therefore constitute State Aid. The Commission draws a distinction between:

(a)"simple interpretation of tax provisions without diverging from habitual administrative practice" (no presumption of selectivity) and
(b)"decisions which diverge from this habitual administrative practice" (selective).

However in reading the Commission's letter, this seems to be a distinction without a difference. The Commission does not seek to consider whether the LTA's decision in the FFT case diverges from the LTA's habitual practice, or from any other tax authorities' habitual practice or from OECD standards, but merely concludes that, based on the Commission's TP analysis, the APA does not respect the arm's length standard. The Commission thus seems to be reserving itself a new role as arbiter of acceptable TP and /or creating a body of TP rules alongside the existing OECD ones.

Conclusion

The action of the EU Commission is comprehensible as a political act, but much less so as a legal or administrative act. The underlying political idea is to make multinationals pay in response to public perception that they are not paying enough. Using the State Aid proceedings in TP matters and targeting a sample of high profile taxpayers, the EU Commission seems to be going far beyond the terms of its mandate. The stakes are high not only in terms of cash impacts for the multinationals concerned but also in terms of transfer pricing practice for both taxpayers and local tax authorities. The sovereign right of a State to assess its taxpayers in line with its TP laws would now, in the Commission's view, be subject to review under State Aid provisions. The EU Commission has thus hung a sword of Damocles over the heads of tax payers and EU Member States. We would expect the matter to reach the ECJ sooner rather than later.

For any further information on this topic, please do not hesitate to contact Keith O'Donnell at Keith.ODonnell@atoz.lu or Emilie Fister at Emilie.Fister@atoz.lu

OECD RELEASES 7 BEPS RECOMMENDATIONS

The Organisation for Economic Cooperation and Development (OECD) released on 16 September 2014 reports with recommendations on 7 actions of its "BEPS" action plan aiming to develop solutions to fight base erosion and profit shifting (BEPS) and ensure that profits are taxed where economic activities generating the profits are performed and where value is created. The reports were presented to the G20 Finance Ministers in Cairns on 20-21 September 2014 for political endorsement, where the G20 Finance Ministers and Central Bank Governors welcomed progress on the OECD BEPS action plan and committed their support to the completion of its work in 2015.

The 7 recommendations deal with the following issues:

- Action 1: Addressing the Tax Challenges of the Digital Economy;
- Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements;
- Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance;
- Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances;
- Action 8: Guidance on Transfer Pricing Aspects of Intangibles;
- Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting;
- Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties.

Please find below the outcome of the main actions of the BEPS action plan.

Neutralise the effects of hybrid mismatches (Action 2 of the BEPS action plan)

BEPS is defined by the OECD as : "tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid". The aim of DTTs and the OECD Model Tax Convention is to eliminate situations of double taxation. However; interactions between domestic tax systems can leave gaps. These gaps result in situations in which the income is not taxed anywhere. A typical situation in which this can happen is when a so-called hybrid instrument is used, i.e. an instrument which is given 2 different tax qualifications by 2 different countries: the jurisdiction of source (jurisdiction of the subsidiary) qualifies, for example, the instrument as a debt instrument and therefore treats the payment made under this instrument as a tax deductible interest payment. The jurisdiction of the Parent Company qualifies the instrument as equity investment and therefore treats the payment received by the Parent Company as a dividend which can benefit from a tax exemption under certain conditions. This mismatch creates a so-called non-taxation.

The report on action 2 gives some recommendations which would eliminate this mismatch and therefore avoid situations of double non-taxation. It recommends:

- linking rules that base the tax treatment of a hybrid instrument on the tax treatment in the other state;
- primary / secondary rule ordering to determine which jurisdiction applies its rules first;
- to deny a deduction for payment or require for it to be included in income.

Very similar rules have already been introduced at EU level, which have to be implemented in Luxembourg, as well as in any other EU member state, by the end of 2015 at the latest.

Even though the Luxembourg implementation of Action 2 will most probably be dependent on the reaction of other countries, the potential for change is high. Since Hybrid instruments are commonly used as a repatriation technique in Luxembourg, a careful review of existing and future investment structures is recommended to select the appropriate instrument.

Harmful tax practices (Action 5 of the BEPS action plan)

The report on harmful tax practices under the BEPS project refers to the work of the Forum on Harmful Tax Practices (FHTP). Based on the report, the FHTP has to deliver the three following outcomes:

- finalisation of the review of member country preferential regimes;
- a strategy to expand participation to non-OECD member countries; and
- consideration of revisions or additions to the existing framework.

To counteract harmful regimes more effectively, Action 5 requires the FHTP to revamp the work on harmful tax practices, with a priority and renewed focus on requiring substantial activity for any preferential regime, improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes and reviews of member and associate country regimes.

Substantial activity requirement

This requirement looks at whether a regime «encourages purely tax-driven operations or arrangements» and states that «many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities».

The report focuses on a preferential tax treatment for certain income arising from qualifying Intellectual Property (IP regimes).

Improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes

Action 5 of the BEPS project requires a renewed focus on transparency and explicitly refers to «compulsory spontaneous exchange of information on rulings related to preferential regimes». This means that the tax authorities have an obligation to spontaneously exchange information if they are aware of information that could be of relevance to another country, even though the information has not been requested by this other country. This applies however only to the extent that the rulings relate to preferential regimes that are within the scope of work of the FHTP and that meet the no or low effective tax rate facto.

Reviews of member and associate country regimes

The review process of the FHTP includes 30 preferential regimes. The report provides a list of countries, the name of the regime and the conclusion reached on certain regimes.

As far as Luxembourg preferential regimes are concerned, the report concludes that the SICAR regime and the SPF regime are not harmful. It furthermore indicates that IP regimes (including the Luxembourg partial exemption IP regime) are still under review and that no decision has been taken yet in this respect.

Treaty benefits (Action 6 of the BEPS action plan)

Action 6 of the BEPS action plan identifies treaty abuse as one of the most important sources of BEPS concerns. The aim of Action 6 is to firstly develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. The second aim of the action is to clarify that tax treaties are not intended to be used to generate double non-taxation and finally, identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. While the aim of double tax treaties and the OECD Model tax Convention is to find solutions to avoid situations of double taxation, interaction of domestic tax systems is becoming more and more of an issue in the globalised world and can leave gaps and produce situations where income is not taxed anywhere.

The report recommends the following approach to address treaty shopping arrangements:

- DTTs should, in their title and preamble, include a statement that the contracting states, when entering into a treaty, intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements;
- a specific anti-abuse rule based on the Limitation On Benefits (LOB) provisions included in the US DTTs should be included:
- Lastly, in order to address other forms of treaty abuse, the report recommends adding a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the Principal Purposes Test, “PPT”, rule) to DDTs.

As far as collective investments vehicles (CIVs) are concerned, compared to the initial draft released in March 2014, the Action 6 report released in September is positive in the sense that the OECD has taken the concerns of the representatives of the various fund industries into account. It states that policy considerations will be addressed to make sure that the proposals included in the Action 6 report do not unduly impact CIVs and non-CIV funds in cases where countries do not intend to deprive them of treaty benefits. This illustrates the understanding of the OECD that the situation of CIVs and non-CIV funds is specific and requires specific provisions in the report. Based on the initial draft, in almost all cases, CIVs would have been denied treaty benefits due to the proposed LOB clause. In the new paper, several alternatives are presented, which vary depending on the situations in which the contracting states may wish to consider that there is no treaty shopping. However, it is stated that in respect to CIVs, further work will be needed. This means that model provisions and related commentary are still drafts and will have to be improved and revised before the final version is released in September 2015. So changes may still be on the horizon.

Finally, the report recommends adding the following new specific treaty anti-abuse rules in respect to:

- the minimum shareholding period for certain dividend transfer transactions;
- changes to article 13(4) to prevent transactions that circumvent the application of the rule dealing with capital gains of shares of property companies;
- changes to the tiebreaker rule for determining the treaty residence of dual resident entities: in this respect, while the initial draft released in March changed the residence criteria for companies in case of conflict and replaced the place of effective management criteria by a mutual agreement procedure, the current report still recommends a mutual agreement procedure but states that countries may wish to maintain the effective place of management criteria as an alternative; and
- situations where the state of residence exempts the income of Permanent Establishments (PEs) situated in third states and where shares, debt claims, rights or property are transferred to PEs set up in countries that either do not tax such income or apply a preferential tax treatment to it.

Whether the recommendations made on treaty abuse, especially the PPT rule, are in line with EU law is doubtful. Case-law of the Court of Justice of the EU has been quite clear on the fact that only wholly artificial arrangements can justify the application of an anti-abuse rule which would restrict EU freedoms (e.g. Cadbury Schweppes (C-196/04). Based on the recommended PPT rule, even structures which reflect the economic reality would be in danger if they have tax motives. So, it remains to be seen, how it will be possible to implement these rules in an EU context. Still, it is clear that structures with companies interposed solely for benefiting from a tax treaty will disappear. Advice is required more than ever to determine the optimal level of substance for any Luxembourg structures, bearing in mind both the commercial and fiscal requirements of any future organisation. The best practice will become the rule and economic substance will have to be in line with the activity performed by the Company.

Transfer Pricing documentation and country–by–country reporting (Action 13 of the BEPS action plan)

The report on Action 13 of the BEPS action plan includes revised standards for TP documentation and a template for country-by country reporting on income, earnings, taxes paid and certain measures of economic activity.

The report provides for the new Chapter V of the OECD TP guidelines that enumerates the objectives for TP documentation requirements, which are:

- to provide the tax administration with the information necessary to conduct informed TP risk assessment and conduct an appropriately thorough audit of the TP practices of entities subject to tax in their jurisdiction; and
- to ensure that taxpayers give appropriate consideration to TP requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns.

In order to achieve these objectives, the report suggests 3 types of TP documentation:

- A master file which provides for a high-level overview of the multinational enterprise group business, its overall TP policies and its global allocation of income and economic activities;

- A local file which includes information helping to meet the objective of assuring that the taxpayer has complied with the arm's length principle in its material TP positions affecting a specific jurisdiction: information relevant to the TP analysis related to transactions taking place between a local country affiliate and associated enterprises in different countries and which are material in the context of the local country's tax system. Such information includes relevant financial information regarding those specific transactions, a comparability analysis, and the selection and application of the most appropriate TP method.

- A country-by-country report, which requires MNEs to report annually and, for each tax jurisdiction in which they do business, the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their total employment, capital, retained earnings and tangible assets in each tax jurisdiction. Lastly, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and provide information on the business activities of these entities.

According to the current timeline, countries participating in the BEPS project will review the TP documentation standards and the country-by-country reporting standards before the end of 2020.

The scope of information that will have to be communicated is very broad and what is sure is that the TP documentation and compliance requirements will increase. It is crucial that all transactions are properly documented and booked. The need for external assistance in compliance matters will increase since standards will have to be developed and put in place internally to achieve and ensure an efficient reporting process.

Multilateral instrument to amend tax treaties (Action 15 of the BEPS action plan)

The purpose of this report is to analyse the tax and public international law issues related to the development of a multilateral instrument enabling countries that wish to do so to implement measures developed in the course of the work on base erosion and profit shifting (BEPS) and amend their bilateral tax treaties. Action 15 is crucial as it analyses the feasibility for the countries to implement recommended measures without having to modify each of the DTTs they have signed in the past.

The report concludes that developing a multilateral instrument is feasible and that legal mechanisms are available to achieve a balanced instrument that addresses both technical and political challenges.

Based on the report, the multilateral instrument could address, among others, the following issues of the BEPS action plan:
- multilateral MAP;
- dual-residence structures;
- hybrid mismatch arrangements;
- so-called «triangular» cases involving PEs in third states; and
- treaty abuse.

Despite the report's positive conclusion on the feasibility of developing a multilateral instrument, it remains to be seen exactly how this will be possible and also how quickly all contacting states will agree on common content.

Alternative recommendations on some of the BEPS actions, such as those regarding CIVs, are expected to vary from country to country. For this reason, we can anticipate that developing global solutions for all countries will be a challenging task.

Next steps

The release of these 7 reports shows that OECD has been able to stick to its very ambitious timeline. It also demonstrates a strong commitment to achieve the objectives set by the OECD/G 20. However, the work of the OECD has not been finalised yet. Some sections of these reports are still drafts and further recommendations are expected to come in the coming months. This is especially true regarding action 6 on treaty abuse. The OECD released on 1 October a new BEPS agenda for the time period October 2014 – July 2015 which indicates that a new discussion draft on Action 6 will be released by mid-November and that a public consultation will take place in January 2015. We will keep you informed of any further developments.

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