Bloomberg BNA

TAX PLANNING INTERNATIONAL REVIEW

International Information for International Business

JUNE 2017

www.bna.com

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Luxembourg Signs the MLI: the Right Choices to Remain Competitive?

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Luxembourg, together with 67 other jurisdictions, has now signed the Multilateral Instrument aimed at implementing tax treaty-related BEPS measures. Luxembourg has adopted the required standards to remain BEPS-compliant, while deciding not to opt into some of the MLI provisions which could be seen as detrimental to competitiveness.

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On the evening of June 7, 2017, Luxembourg, together with 67 other jurisdictions, signed the Multilateral Instrument ("MLI") aiming to implement the tax treaty-related measures deriving from the OECD Base Erosion and Profit Shifting ("BEPS") Project. Eight additional countries signed a letter expressing their intention to sign the MLI. The MLI is a comprehensive and flexible convention that allows countries to implement a wide range of tax treaty related BEPS measures with many options and alternatives.

Not all 81 Luxembourg tax treaties listed by Luxembourg will be affected, as both the Luxembourg and the foreign jurisdiction have to have signed the MLI (25 countries including the U.S. do not intend to sign), adopted matching options/alternatives and ratified the MLI in order for the changes to enter into force.

Luxembourg has adopted the minimum standards to remain BEPS-compliant, while deciding not to opt into some of the MLI provisions which could be seen as detrimental to competitiveness (limitation on benefits, immovable property provision, dual residence, rules on dividend transfer transactions, some of the rules on the avoidance of permanent establishment status, some of the hybrid mismatch rules for transparent entities, etc.).

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Luxembourg's choices can be interpreted as positive, as care has been taken not to complicate the current situation of taxpayers while also opting for additional legal certainty through the adoption of the binding arbitration procedure, helping mitigate situations of double taxation.

What is the Purpose of the MLI and how does it work?

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 provides for the development of a MLI in order to allow countries to swiftly modify 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 BEPS Project participants were not able to reach the same level of consensus on all 15 BEPS Actions, it was necessary for the MLI to provide for sufficient flexibility to allow countries to choose which MLI provisions they wish to adopt.

Parties to the MLI are required to adopt the text of a new preamble and the principal purpose test ("PPT") in their tax treaties (i.e. so-called minimum standard measures):

- The preamble 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. However, tax treaties which already include such clause do not have to be modified by the MLI in this respect.
- The PPT states that benefits provided in the tax treaty shall not be granted if it is reasonable to conclude, in light of all relevant facts and circumstances, that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in the benefit (unless it is established that granting the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions).

Otherwise, the MLI allows parties to

- choose the tax treaties that should come within the scope of the MLI;
- opt out of (some) provisions; and
- choose to apply optional provisions and alternative provisions.

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.

For a covered tax treaty to be modified, 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 has not adopted an identical option/alternative, the existing tax treaty will not be modified. Therefore, given the different approaches and interests of participating countries, it remains to be seen which Luxembourg treaties will finally be modified by the MLI and 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".

Which are the Luxembourg Tax Treaties Covered by MLI Modifications?

As stated above, not all 81 Luxembourg tax treaties will be impacted by the MLI, given that not all these 81 contracting states have signed or will sign the MLI. In addition, to determine which of the tax treaty rules will be modified by the MLI, it will be necessary to analyze the position of each country on each of the MLI provisions.

For now, what is sure is that the following 54 tax treaties concluded by Luxembourg will be modified by the MLI, at least as far as the minimum standards are concerned (but only to the extent the tax treaties with these countries do not already include those standards):

Andorra, Armenia, Austria, Belgium, Bulgaria, Canada, China, Croatia, Czech Republic, Denmark, Finland, France, Georgia, Germany, Greece, Guernsey, Hong Kong (China), Hungary, Iceland, India, Indonesia, Ireland, Isle of Man, Israel, Italy, Japan, Jersey, Korea, Latvia, Liechtenstein, Lithuania, Malta, Mexico, Monaco, Netherlands, Norway, Poland, Portugal, Romania, Russia, San Marino, Senegal, Serbia, Seychelles, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom and Uruguay.

In addition, given that Mauritius and Tunisia expressed their intention to sign the MLI, the Luxembourg tax treaties concluded with these two additional countries may be modified as well.

Did Luxembourg Make the Right Choices?

Luxembourg has decided to make sure that all of its 81 tax treaties currently in force fall within the scope of the MLI. However, this decision does not mean that all these tax treaties will be modified by the MLI and this, for the following reasons:

- Some of the jurisdictions with which Luxembourg has a tax treaty in force have not signed and do currently not intend to sign the MLI. This is the case for 25 countries (including, for example, the U.S.) out of the 81 countries with which Luxembourg has a tax treaty in force. Therefore, the tax treaties concluded with these 25 countries will remain unchanged.
- For a covered tax treaty to be modified by the MLI, both Contracting States have to adopt matching

options/alternatives. Hence, if Luxembourg is in favor of a certain provision while the other Contracting State did not adopt an identical approach, the existing tax treaty will remain unchanged in respect of these provisions. Thus, to know whether and what provisions of a tax treaty will or not be modified by the MLI, an analysis of the approach taken by all Luxembourg tax treaty partners will have to be performed.

- Lastly, the tax treaty will only be modified to the extent both Luxembourg and its treaty partners ratify the MLI.

The Right Choices to Remain Competitive

When selecting the measures which would modify its tax treaties in the near future, Luxembourg had to ensure that its approach was not more restrictive than its main competitors. Some of the competitors of Luxembourg, like the U.K., announced months ago that they would opt for an approach aiming at implementing only those MLI measures which are minimum standards in accordance with the conclusions reached in the BEPS reports. This decision had to be taken into account by Luxembourg when making its own choices in order for the Grand Duchy to remain competitive among competing jurisdictions.

In addition to the minimum standards (preamble and PPT) described above, Luxembourg has taken, among others, the following positions:

- Luxembourg decided not to opt into a so-called simplified limitation on benefits "(LOB") provision which would deny treaty benefits if a resident is not a qualified person.
- Luxembourg further decided to not introduce the modifications 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 of wide application which can be problematic for investors in that it may create situations of 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 could choose 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. Given Luxembourg's position as a major hub for the structuring of cross-border real estate investments, the fact that Luxembourg did not opt for these provisions is good news as it could appear detrimental for investors and not in Luxembourg's interest.
- Luxembourg will not introduce the MLI rules on dividend transfer transactions.
- As far as the concept of permanent establishment ("PE") is concerned, Luxembourg will not introduce the rules on PE situated in third jurisdictions and artificial avoidance of PE status through commissionnaire arrangements and similar strategies. It will further not introduce the rules aiming at preventing the artificial avoidance of a PE through splitting up contracts. However, Luxembourg has decided to adopt one of the two options on the artificial avoidance of PE status through specific activity exemptions.
- Finally, Luxembourg will not introduce some of the rules of the MLI on hybrid mismatches dealing with transparent entities.

The Right Choices to Establish Clear and Practical Tax Rules

In its choices, Luxembourg also had to make sure not to complicate the situation of Luxembourg taxpayers. One example to illustrate this is the optional provision of the MLI on dual resident companies, determining that in the case of a company with a dual residence, the competent authorities of both Contracting States shall endeavor to determine, by mutual agreement, the state of residence of the company.

So far, almost all tax treaties include a 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.

Taking into account the fact that the tie-breaker rule is a tried and tested concept that provides reliable results which do not depend on unpredictable negotiations between tax authorities in different jurisdictions (which may take several years), Luxembourg has decided not to opt into the new rule on dual residence of a company. This decision is very positive.

The Right Choices to Improve Legal Certainty

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 that they have entered into. These disputes, which involve 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. A well-functioning dispute resolution is necessary in order to protect taxpayers against potential arbitrary decisions of foreign tax authorities. This provision is indispensable given our current environment of chronic uncertainty.

The MLI addresses these concerns and provides for some measures 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 situations of (economic) double taxation. Despite the existence of similar rules at EU level, it made sense to apply these provisions which should only be beneficial for Luxembourg resident taxpayers.

The same is true in respect of arbitration. The binding arbitration procedure provided in the MLI will give multinational enterprises, facing double taxation due to adjustments of their profits, a remedy that obliges the Contracting States to resolve the double taxation. Despite similar rules having been introduced very recently at EU level, it made sense to opt, which Luxembourg did, into this system as it could help to

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ISSN 0309-7900

mitigate double taxation resulting from disputes with foreign tax authorities, even in a non-EU context. This is why Luxembourg opted to adopt these rules.

Next Steps

Many countries had already announced that they would not be adopting a large part of the proposed provisions, therefore "cherry picking" the MLI. Thus, the decision taken by Luxembourg of not opting into certain measures is fully legitimate. It can also be seen as positive because it will ensure that the signature of the MLI does not bring about changes which would put Luxembourg at a competitive disadvantage when compared to other jurisdictions.

Ultimately, if foreign jurisdictions would like to include a selection of these measures in their tax treaty with Luxembourg, the tax treaty may still be modified through a bilateral protocol and the Luxembourg treaty negotiators retain the possibility to ask for something in return (e.g., a reduced withholding tax rate on interest and dividends for Luxembourg investment funds).

Since the modification of a tax treaty by the MLI is subject to several conditions, an analysis of the approach taken by all Luxembourg tax treaty partners is necessary in order to determine which tax treaty will ultimately be impacted. Taxpayers with Luxembourg structures relying on tax treaty benefits should seek the advice of their tax adviser in order to determine whether relevant tax treaties will or will not be modified by the MLI and whether the potential changes to be introduced may challenge the efficiency of their structure.

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