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ATOZ TAX ALERT

09 June 2017

Luxembourg Signs MLI to Implement Tax Treaty related BEPS Measures

At a glance

- On 7 June 2017, at the official signing ceremony, Luxembourg signed the Multilateral Instrument (MLI) aiming to implement the tax treaty-related measures deriving from the OECD Base Erosion and Profit Shifting (BEPS) Project.
- Not all 81 Luxembourg tax treaties will be affected as both the Luxembourg and foreign jurisdiction have to have signed the MLI (25 countries including the United States 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 certain provisions which could be seen as detrimental to competitiveness (Limitation on benefits, immovable property provision, rules on dividend transfer transactions, some permanent establishment rules, hybrid mismatches for transparent entities, dual residence, etc.).
- Luxembourg's choices can be interpreted as positive, as care has been taken not to complicate the current situation of tax payers while also opting for additional legal certainty through the adoption of the binding arbitration procedure, helping mitigate situations of double taxation.

Introduction

On the evening of 7 June, 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. Which approach has been taken by Luxembourg to remain competitive in a more and more harmonised tax world and which of the Luxembourg tax treaties will be amended by the MLI?

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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 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 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 purposes 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 amended 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.

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

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 amended 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 United States) out of the 81 countries with which Luxembourg has a tax treaty. Therefore, the tax treaties concluded with these 25 countries will remain unchanged.

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- For a covered tax treaty to be amended 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 amended 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 amended to the extent both Luxembourg and its treaty partners ratify the MLI.

The right choices to remain competitive

When selecting the measures which would amend 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 UK, 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 amendments to the so-called immovable property company clause, 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. Luxembourg being a major hub for the structuring of cross-border real estate investments, the fact that Luxembourg did not opt for this provisions is good news as it could appear detrimental for investors and not in Luxembourg's interest.

- Furthermore, Luxembourg will not introduce the MLI rules on dividend transfer transactions, permanent establishments situated in third jurisdictions and artificial avoidance of permanent establishment status through commissionnaire arrangements and similar strategies.

- 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 tax payers. 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.

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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 provisions 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 tax payers.

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 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.

What's next?

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 make sure 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 amended 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 amendment 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. Tax payers 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 amended by the MLI and whether the potential changes to be introduced may challenge the efficiency of their structure.

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TAX ADVISERS
LUXEMBOURG

Can we help? Do you have further questions?

KEITH O'DONNELL
Managing Partner
International & Corporate Tax
keith.odonnell@atoz.lu
T + 352 26 940 257

OLIVER R. HOOR
Partner
International & Corporate Tax
oliver.hoor@atoz.lu
T + 352 26 940 646

SAMANTHA SCHMITZ-MERLE
Director
Knowledge
samantha.merle@atoz.lu
T + 352 26 940 235

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