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LUXEMBOURG

INSIGHTS

JUNE 2017

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EDITORIAL

Greetings,

Spring started with the announcement of a new Luxembourg IP regime. The regime, which will be BEPS-compliant, was announced by Prime Minister Xavier Bettel during his annual State of the Nation speech. This announcement had been much anticipated following the repeal of the former Luxembourg IP regime by the 2016 budget law. Even though draft legislation is not yet available, it is nevertheless possible to anticipate some of the key aspects of the new regime.

Additional changes to the Luxembourg legislation may come soon following two recent decisions of the Court of Justice of the European Union (CJEU): in the Berlioz case which dealt with Luxembourg rules on exchange of information upon request, the CJEU demonstrated that being too transparent may be problematic from an EU standpoint; in the other case, the CJEU decided that the Luxembourg VAT rules applicable to independent groups of persons were not in line with the EU VAT Directive.

We further examine the framework for the delegation or outsourcing of investment management services by Luxembourg AIFMs following the release of the recent ESMA opinion on the relocation of investment firms from the UK to other EU Member States.

At EU level, the proposal amending the Anti-Tax Avoidance Directive, "ATAD" has now been formally adopted and became a Directive (the so-called "ATAD 2 Directive"). We examine the changes introduced by this new Directive, which Luxembourg will have to implement by 2020 at the latest. Also at EU level, an agreement was reached on a new Directive aiming at improving dispute resolution mechanisms in the EU. We present and analyse the changes introduced.

At global level, one of the most significant disruptions in the history of international taxation happened on 7 June 2017 with the signature by 68 jurisdictions of the Multilateral Instrument (MLI) aiming to implement the tax treaty-related measures deriving from the OECD BEPS Project. 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. In this issue, we analyse the approach taken by Luxembourg in respect to the options and alternatives chosen.

We hope you enjoy these insights.

The ATOZ Editorial Team

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NEW IP REGIME TO BE INTRODUCED IN 2018

OUR INSIGHTS AT A GLANCE

- During the 2017 State of the Nation Speech, Prime Minister Xavier Bettel announced that a new IP regime would be introduced in Luxembourg, replacing the one which was repealed in 2016
- The new regime, which will be released in the coming weeks, will be BEPS-compliant and consistent with the OECD report on Action 5 of the BEPS action plan which requires countries to adopt the modified nexus approach
- Under the modified nexus approach, only IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are considered as functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, where such processes are relevant
- In order to encourage R&D development, the amount of IP income that can benefit from the exemption depends on the amount of R&D expenditures incurred by the company and which gave rise to the IP income

On 26 April 2017, Prime Minister Bettel gave his annual State of the Nation speech. During the speech, the introduction of a new IP (intellectual property) tax regime was announced. This announcement is welcome and has been much anticipated following the repeal of the former Luxembourg IP regime by the 2016 budget law. The draft law introducing the new regime is expected to be released in the coming weeks.

Repeal of the former Luxembourg IP regime

The repeal followed the release of the report on Action 5 of the BEPS Action plan: *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*. This report sets the conditions for an IP regime to be considered as not harmful and thus “BEPS-compliant”.

The report states that countries with IP regimes in place which are not consistent with the modified nexus approach are required to amend their regimes. It provides further that there should be no new entrants to such IP regimes after 30 June 2016. Finally, taxpayers benefiting from regimes in place that do not comply with the nexus approach would no longer be able to receive any additional tax benefits from those regimes after 30 June 2021.

Given that the former Luxembourg IP regime, like several other foreign IP regimes, did not meet the requirements defined in the BEPS report on the modified nexus approach, it had to be amended. However, in the interest of acting quickly and efficiently, instead of amending the existing IP regime to make it BEPS-compliant the Luxembourg government decided to abolish the existing regime in a first step and announce that a replacement regime would be subsequently introduced, in line with the requirements defined in the BEPS report.
Formerly, Luxembourg provided an IP regime which applied at two levels, one for income tax purposes and a second for net wealth tax (NWT) purposes. This means that the regime had to be abolished at both levels:

- IP 80% income tax exemption regime

The 80% income tax exemption regime which applied to income arising from qualifying IP assets and capital gains on the sale of such assets was repealed from 1 July 2016. For IP rights created or acquired before 1 July 2016, a transitional period runs from 1 July 2016 until 30 June 2021, during which the exemption regime remains applicable. However, the regime no longer applies from 31 December 2016 if the IP was acquired from a related party after 31 December 2015, except if it was acquired from a party which had already benefited from the Luxembourg IP regime or a corresponding foreign IP regime at the time of the transfer.

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- IP 100% NWT exemption regime

The 100% NWT exemption which applied to qualifying IP assets for NWT purposes was repealed as of 1 January 2017. For IP rights created or acquired before 1 July 2016, a transitional period runs until 1 January 2021 included, during which the NWT exemption remains applicable. However, the NWT exemption will no longer apply as from 1 January 2018 if the IP was acquired from a related party after 31 December 2015, except if the IP was acquired from a party which had already benefited from the Luxembourg IP regime or a corresponding foreign IP regime at the time of the transfer.

What could the new Luxembourg IP regime look like?

Following the announcement on 26 April 2017, it is now clear that the Luxembourg government intends to put its new IP regime in place as early as 2018. However, no details were provided in the speech regarding the new regime, although a number of proposals have been circulated. It will be necessary to await the release of the draft legislation to determine the approach taken.

What is clear is that the new regime will have to be in line with the so-called "modified nexus" approach defined in the BEPS Action 5 report:

- IP assets covered

According to the modified nexus approach, the only IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are considered as functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, where such processes are relevant. Based on the BEPS Action 5 report, IP assets that are functionally equivalent to patents are (i) patents defined broadly, (ii) copyrighted software, and (iii) in certain circumstances, other IP assets that are nonobvious, useful, and novel. Here, it remains to be seen how Luxembourg will interpret this definition and which assets will be considered as falling within the scope of this category.

- Amount of IP income which can benefit from an exemption

The modified nexus approach aims to ensure that IP regimes, since they are intended to encourage R&D activity, only provide benefits to taxpayers that do in fact engage in such R&D activities. As a consequence, according to the modified nexus approach, a taxpayer will be able to benefit from an IP regime only to the extent that it can demonstrate that it did incur expenditures, such as R&D, which gave rise to the IP income.

The nexus approach which determines what income may receive tax benefits is as follows:

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Overall income from IP asset} = \text{Income receiving tax benefits}$$

This means that if a company has only one single IP asset and incurs all of expenditures to develop that asset itself, the nexus approach will allow all of the income from that IP asset to qualify for tax benefits.

When computing the amount of qualifying expenditures, jurisdictions may allow taxpayers to apply a 30% "up-lift" to expenditures that are included in qualifying expenditures. This up-lift may increase qualifying expenditures but only to the extent that the taxpayer has non-qualifying expenditures. It means that the increased amount of qualifying expenditures may not exceed the taxpayer's overall expenditures.

Since the possibility to increase the amount of qualifying expenditures up to 30% is optional for States, it remains to be seen whether Luxembourg will make use of this option. However, since it can be expected that the Luxembourg government will be willing to make sure that the most competitive regime as possible is available for taxpayers, one can expect that this possibility will be provided by the new regime.

The report expands further on what is to be understood as qualifying expenditures, overall income from IP assets and overall expenditures incurred to develop IP assets when computing the income that may benefit from the regime. In addition, the report explains what would occur in the case of IP asset acquisition (as opposed to an IP asset developed in-house) and in the case of R&D outsourcing.

Next steps

The announcement made by the Luxembourg government on the upcoming introduction of a new IP regime is good news. The new regime will be positive for both Luxembourg taxpayers and for Luxembourg itself as the regime should attract new R&D activities to Luxembourg and strengthen existing activities. In the future, IP regimes in countries participating in the BEPS project will become more and more similar, given that they will all have to be in line with the modified nexus approach. To remain competitive and make sure that the new regime is as attractive as possible, Luxembourg will have to make the right choices and exhaust all options provided in the BEPS report (e.g. broad definition of qualifying IP income, 30% up-lift on qualifying expenses, etc.). We will know more about the new regime as soon as the text of the draft legislation is released and will update you on any developments.

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BERLIOZ SETS THE TONE FOR THE EXCHANGE OF INFORMATION

OUR INSIGHTS AT A GLANCE

- The Court of Justice of the European Union recently handed down a decision in a case dealing with the Luxembourg rules on exchange of information upon request
- The ruling of the CJEU clarified a significant number of concepts that the Directive 2011/16 introduced which were subject until now to broad interpretation, including *inter alia* the fact that the requested Member State has to verify the foreseeable relevance of the information that is being requested so as to safeguard against any fishing expeditions by requesting Member States

The Court of Justice of the European Union rendered a judgment on 16 May 2017 following a preliminary ruling that the Luxembourg Administrative Court referred to, following a complaint that was introduced by Berlioz S.A. This article explains the Luxembourg legal and case law context that led to the judgment of the Court of Justice the European Union (CJEU).

Context

- *Legal background*

In the aftermath of the G20 meeting held in London in 2009, the OECD published a series of lists categorising jurisdictions according to how fully they have implemented internationally agreed tax standards. In addition to a black and white list, there was a grey list which comprised two sub-categories: (i) tax havens on one hand and (ii) other financial centers on the other hand. Luxembourg was amongst the financial centers listed on the grey list.

This “grey-listing” acted as a wake-up call and led Luxembourg to undertake various reforms which included treaty renegotiation, as well as the introduction of a law in March 2010 that provided for a procedure for the exchange of information upon request. The efforts notwithstanding, in the November 2013 peer-review report of the Global Forum on Transparency and Exchange of Information for Tax Purposes, Luxembourg was still considered non-compliant because almost all cases brought before the Administrative Court were ruled in favour of the taxpayer on the basis that the information requested was not considered as foreseeably relevant. This culminated in the amendment of the March 2010 law in November 2014 whereby the Luxembourg tax authorities only had to verify the formality of the request for exchanging information. The law more specifically provides that a request satisfies this condition where it contains an indication of (i) the legal basis and (ii) of the competent authority from which the request is issued. In other terms, the tax authorities are no longer allowed to decline a request on the grounds that the requested information lacks relevance. According to the law, where the Luxembourg tax authorities are not in possession of the information that is being requested, the director of the Luxembourg tax authorities is required to subpoena the holder of that information, thereby ordering it to provide the necessary evidence. Where the holder of the information knowingly refuses to respond to that subpoena, a fine of up to EUR 250,000 may be imposed. The law finally specifically provides that no challenges may be brought by the taxpayer against the order issued by the requested tax authorities.

- *The Luxembourg litigation*

The French tax authorities sought information from the Luxembourg tax authorities to assess whether Cofima SAS (“Cofima”), a French company, was entitled to distribute dividends to its Luxembourg shareholder, Berlioz S.A. (“Berlioz”), a public limited liability company, free of withholding tax. This led the Luxembourg tax authorities to subpoena Berlioz to provide a list of information. Berlioz refused to provide some of the requested information on

the grounds that it was not foreseeably relevant within the meaning of the EU Directive 2011/16 for the assessment as to whether the dividend distributions made by Cofima should be subject to a withholding tax. This partial refusal on the part of Berlioz resulted in the Director of the Luxembourg tax authorities imposing a EUR 250,000 fine on Berlioz. Within the delays prescribed by law, Berlioz brought a claim before the Administrative Tribunal against the decision of the Director of the Luxembourg direct tax authorities imposing the fine, and asked that tribunal determine whether the information order was well founded. The Administrative Tribunal upheld, in part, the main action for variation and reduced the fine to EUR 150,000 but dismissed the action as to the remainder, holding that there was no need to adjudicate on the action for annulment that was being brought.

An appeal was timely lodged by the plaintiff before the Administrative Court maintaining that the refusal of the Administrative Tribunal to determine whether the information order was well founded constituted a breach of its right to an effective judicial remedy as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms (the "ECHR"). The Administrative Court considered that it would be necessary to take account of Article 47 of the Charter of the Fundamental Rights of the European Union (the "Charter"), which mirrors the right referred to by the ECHR. It decided to stay the proceedings and to refer a number of questions to the CJEU for a preliminary ruling.

The ruling of the CJEU

The judgment of the CJEU was issued on 16 May 2017 following the conclusions of the Advocate General of 10 January 2017.

In its judgment, the CJEU ruled that a Member State implements EU law, and that the Charter is therefore applicable, when that Member State makes provision in its legislation for a pecuniary penalty to be imposed on a relevant person who refuses to supply information in the context of an exchange between tax authorities based, in particular, on the provisions of Directive 2011/16. This conclusion applies irrespective of the fact that the pecuniary penalty is provided for in a law that was not the one transposing the said Directive. This is due to the fact that the application of the national provision is intended to ensure the application of the Directive.

The CJEU further ruled that Article 47 of the Charter must be interpreted as meaning that a relevant person on whom a pecuniary penalty has been imposed for failure to comply with an administrative decision directing that person to provide information in the context of an exchange between national tax authorities (pursuant to Directive 2011/16) is entitled to challenge the legality of that decision. This conclusion of the CJEU is a material departure from the Luxembourg 2014 law which specifically prohibits any challenges by a taxpayer that refuses to comply with an order issued by the Luxembourg tax authorities - as a requested authority – to supply information.

Moreover, the recitals to the Directive 2011/16 notably state that the standard of "foreseeable relevance" is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Member States are not at liberty to engage in "fishing expeditions" or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer. The Luxembourg law of November 2014 simply sets out that the Luxembourg tax authorities have to verify the formality of the request for exchanging information, and more specifically that a request satisfies this condition where it contains an indication of (i) the legal basis and (ii) the competent authority from which the request is issued. The CJEU, in its judgment, rules that the 'foreseeable relevance' of the information requested by one Member State from another Member State is a condition which the request for information must satisfy in order for the requested Member State to be required to comply with that request. Therefore, 'foreseeable relevance' is a condition of the legality of the information order addressed by that Member State to a relevant person and of the penalty imposed on that person for failure to comply with that information order.

The CJEU goes even further in its judgment in that it rules that verification by the requested authority to which a request for information has been submitted by the requesting authority is not limited to the procedural regularity of that request, but must enable the requested authority to be assured that the information sought is not devoid of any foreseeable relevance with regard to the identity of the taxpayer concerned, that of any third party asked to provide the information and to the requirements of the tax investigation concerned.

Finally, in the context of a judicial review by a court of the requested Member State, that court must have access to the request for information addressed to the requested Member State by the requesting Member State. The concerned person should also have access to information, albeit at the minimal end of the spectrum, as well to the tax purpose for which the information has been sought so that he may be given a right to a fair hearing regarding the condition of foreseeable relevance. That person does not, however, have a right of access to the whole of that request for information, which is to remain a secret document in accordance with the Directive. Here again, the CJEU's ruling departs from the strict provision of the 2014 law that simply forbade that there be a disclosure of the information request.

Conclusion

This judgment issued by the CJEU is most welcome in that it clarifies a significant number of concepts that the Directive 2011/16 introduced which were subject until now to broad interpretation. It indeed *inter alia* clarifies that the requested

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Member State has to verify the foreseeable relevance of the information that is being requested so as to safeguard against any fishing expeditions by requesting Member States.

Furthermore, the judgment is of great importance to the EU and international initiatives in the field of exchange of information in that while it concurs with the general idea and principle that greater tax cooperation through greater communication and exchange of information amongst tax administrations is necessary to tackle tax fraud and tax evasion, it sets some limits which, when complied with, act to preserve certain legal fundamentals that are deeply enshrined in our judicial systems.

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COST-SHARING EXEMPTION: OUTCOME OF THE CASE COMMISSION V LUXEMBOURG

OUR INSIGHTS AT A GLANCE

- On 4 May 2017 the CJEU handed down its decision in the case Commission v Luxembourg relating to Luxembourg VAT rules applicable to Independent Groups of Persons (IGPs) to their members
- Following the opinion of the advocate general Kokott, the CJEU ruled that the implementation of the IGP regime in accordance with the VAT legislation in Luxembourg does not comply with the EU VAT Directive
- For example, the Luxembourg VAT Law provides that services rendered by an IGP to members carrying on taxable activities that do not exceed 30% (or 45% under certain conditions) of their annual turnover are exempt from VAT, but according to the Court ruling, services rendered by the IGP in relation to the VAT taxable activity of the members should not be covered by the VAT exemption
- In the light of this CJEU decision, it is clear that the current Luxembourg regime will have to be revised and that the impacts in the financial sector are likely to be material.

On 4 May 2017, the Court of Justice of the European Union ("CJEU") released its judgment in the case Commission v Luxembourg (C-274/15) regarding the Luxembourg VAT rules applicable to Independent Groups of Persons (also known as "IGPs" or "cost-sharing" groups) to their members.

Pursuant to article 132, § 1, f) of the EU VAT Directive, the supply of services by independent groups of persons to their members which are either VAT exempt taxable persons, or non-taxable persons, are exempt of VAT. For the VAT exemption to apply, these services must be directly necessary to sustain each member's VAT exempt or non-business activities. In addition, payments made by the members to the IGP must be the exact reimbursement of the joint expenses and no distortion of competition shall result from the VAT exemption.

The aim of the IGP regime is to avoid a VAT cost on support services pooled at the level of the IGP (staff, payroll services, etc.). Without this specific VAT exemption, the services rendered by the IGP would be subject to VAT which would constitute a final cost for the members carrying on activities with no VAT deduction right.

Following the opinion of the advocate general Kokott, the CJEU ruled that the implementation of the IGP regime in accordance with the VAT legislation in Luxembourg does not comply with the EU VAT Directive.

The Luxembourg VAT Law provides that services rendered by an IGP to members carrying on taxable activities that do not exceed 30% (or 45% under certain conditions) of their annual turnover are exempt from VAT. In this regard, the Court ruled that the exemption can only apply if services rendered by the IGP are directly necessary for the VAT exempt or the non-taxable activities of the members. Services rendered by the IGP in relation to the VAT taxable activity of the members should therefore not be covered by the VAT exemption.

Under the Luxembourg VAT Law and based on their VAT recovery ratio, the members of an IGP may deduct the VAT borne by the IGP

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on purchases from third parties. By recalling that the IGP is an independent taxable person which is distinct from its members, the Court ruled that only the IGP is entitled to claim a right of deduction and not its members.

Lastly, the allocation of costs (notably staff costs) by the members to the IGP has to be considered as falling within the scope of VAT. In Luxembourg, these allocations are considered as outside the scope of VAT.

In the light of this CJEU judgment, it is clear that the current Luxembourg regime will have to be revised and that the impacts in the financial sector are likely to be material.

It is also important to note that the CJEU has been called upon to render its judgments in three other cases related to the IGP regime in the coming months. In the case Commission v Germany (C-616/15), the Court will have to determine whether this VAT exemption should be limited to members carrying on activities in the public interest (and not to the financial sector). Cross-borders IGP and interactions with transfer pricing rules will be addressed by the CJEU in the DNB Banka (C-326/15) and Aviva (C-605/15) cases. The outcome of these cases will also define the scope of the VAT exemption and may potentially lead to additional amendments of the Luxembourg VAT regime, if the latter is maintained.

For further information or assistance with VAT matters, please contact Thibaut Boulangé at thibaut.boulange@atoz.lu.

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DELEGATION AND OUTSOURCING FRAMEWORK FOR LUXEMBOURG AIFMS

OUR INSIGHTS AT A GLANCE

- Asset managers intending to have boots on the ground in Luxembourg must carefully structure their relationship with their AIFM
- Certain functions may either be delegated or outsourced by the AIFM, which shall retain certain powers and responsibilities
- The diversity of options available and the refinement of the contractual arrangements that may be set up should allow each and every one to find the perfect fit

There are many reasons why the sponsor of an Alternative Investment Fund (AIF) should consider establishing a Luxembourg AIFM, or appointing a Luxembourg independent AIFM[1]:

- a non-EU fund manager is looking for an access to the European alternative investment funds market;
- a UK fund manager in a post Brexit era, wishes to maintain its continuous access to that growing market;
- an EU fund manager facing an increasingly challenging environment, willing to increase its presence in Luxembourg and to develop its funds in a consistent and sustainable way.

In all cases, the sponsor must determine the extent to which certain functions can be delegated or outsourced by the AIFM - notably back to it or to an entity under its control - as well as the powers and responsibilities the AIFM must retain. The arrangements would typically unfold under two models: the delegation model and the outsourcing model.

1. The delegation model

The delegation of core functions[2] by an AIFM is strictly defined and heavily supervised by the national competent authorities. There are a number of conditions an AIFM must meet *ab initio* and on an on-going basis, when resorting to delegation.

An AIFM set up in Luxembourg can delegate some of its functions, but not all, and not to the extent it would become a letter-box entity. When it comes to investment management, typically, in practice, the portfolio management function is delegated, in its entirety or only partly. Alternatively, some or all aspects of risk management may be delegated as well.

When portfolio management is delegated, the delegate must be authorised to carry out portfolio management activities and must be supervised by a competent authority in its jurisdiction; otherwise, a special derogation from this condition can be requested from the Luxembourg supervisory authority, the CSSF. Nevertheless, the AIFM retains full responsibility for the delegated tasks and functions. The delegate must bear in mind that it will be under the regular and effective supervision of the AIFM and will therefore be exposed to inquiries and on-site visits by the CSSF.

The delegate effectively makes the investment and divestment decisions. However, the delegate is only considered as a service provider to the AIFM (and not to the AIF), and it is only the latter who can be considered as managing the AIF. Moreover, the AIFM

[1] In a previous piece we weighted the advantages and pitfalls of setting up an own AIFM against those of contracting with an independent AIFM: http://www.atoz.lu/sites/default/files/atoz_flipbook/atoz-insights-april-2017/index.html#p=10

[2] The delegation rules apply not only to the delegation of portfolio management and risk management, but also to the delegation of the administration and marketing functions and of the activities relating to the assets of the AIFs. These will also weigh in the balance when the supervisory authority assesses whether the AIFM is a letter-box entity or not

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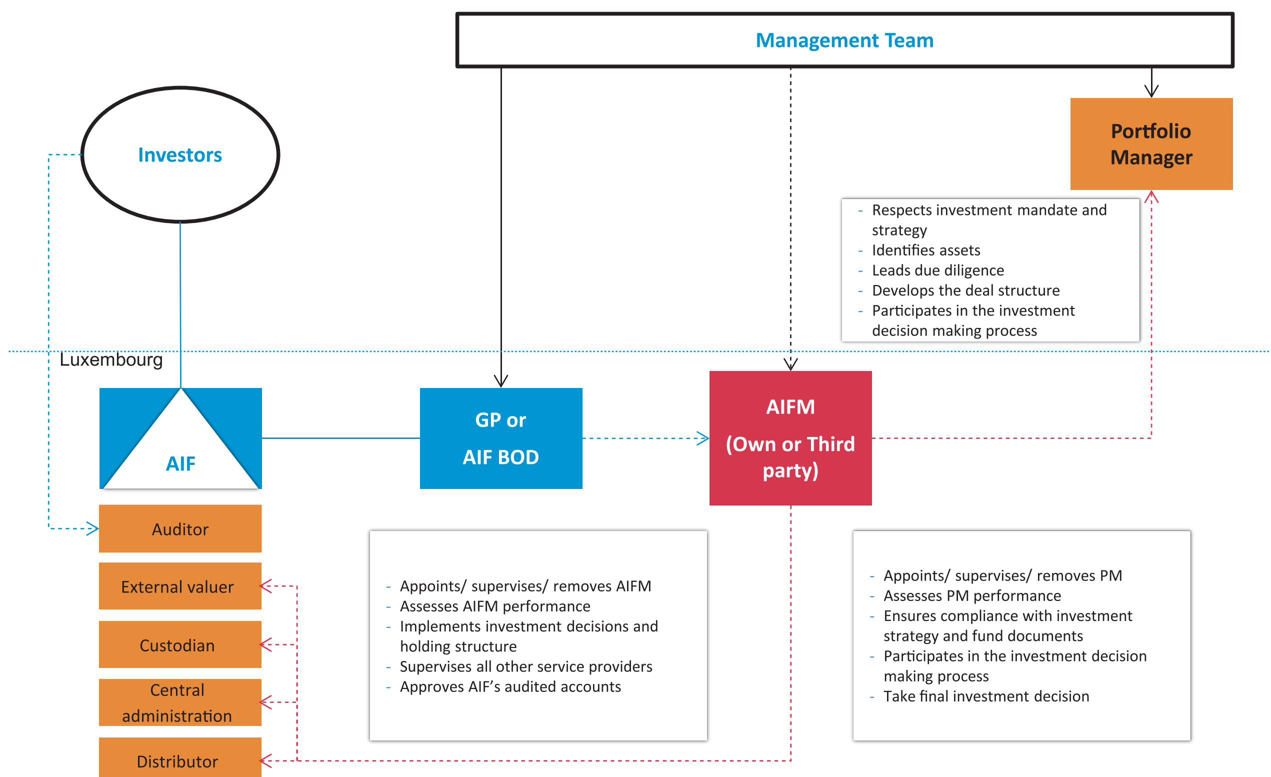
must ensure that the investment decisions taken by the delegate are executed according to the investment objectives, strategy and the risk restrictions of the funds managed, and that the portfolio is managed in accordance with the investment diversification criteria laid down by the AIFM. The Luxembourg AIFM, on the other hand, must retain the power (and implicitly allocate sufficient resources) to take senior management decisions, notably to implement the investment policy and strategy of the AIFs. It must be able to direct and control the performance of the delegated function or activity.

Given the strict conditions for the delegation of the investment management functions, the AIFM would need to ensure that the delegation to the asset manager does not circumvent its own responsibilities, obligations and liabilities toward the AIF and the investors in the AIF. Therefore, the AIFM will claim the right to monitor the delegate, and, where the investors' interests dictate it, to have a flexible contractual right to immediately withdraw and terminate the relationship. The AIFM should also be granted rights of access and inspection of the delegate's premises or permission to obtain information from it, as well as the right to be asked to approve any sub-delegation in advance.



2. The outsourcing model

In this operational model, the AIFM would exercise both functions of investment management, that is to say portfolio and risk management. However, with respect to the portfolio management, it would generally rely on the advice to be provided to it by one of the entities in the sponsor's group, acting as investment adviser. The investment adviser will have a consultative voice only, but no decisional power over the investments to be made. The investment adviser undertakes the research and provides recommendations as to the investments to be made by the AIF, but the investment decisions are taken by the AIFM.

Like in the delegation model, the outsourcing arrangement should not impact the business continuity, confidentiality or conflict of interest' resolution mechanisms of the funds managed. For instance, carrying out portfolio management tasks would be deemed in conflict with the performance of audit or compliance functions. Similarly, a portfolio manager would be in a situation of conflict of interest if it also carried out market making or underwriting activities.

This arrangement is suitable when no potential delegate is authorised for asset management in the relevant jurisdiction or when the CSSF does not consent to the delegation of core functions.

[2] In the EU it would be a MiFID firm authorised to provide investment management. When portfolio management is delegated to an entity outside the EU, in addition to the conditions listed, there must be a written cooperation agreement between the CSSF and the supervisory authority of the home state of the delegate, which would enable the CSSF to carry out inspections and inquiries and to enforce sanctions in case of breaches. CSSF signed over 40 MOUs at the time of writing. In the event of the United Kingdom's exit from the Single Market, a cooperation agreement between the CSSF and the Financial Conduct Authority will be required.

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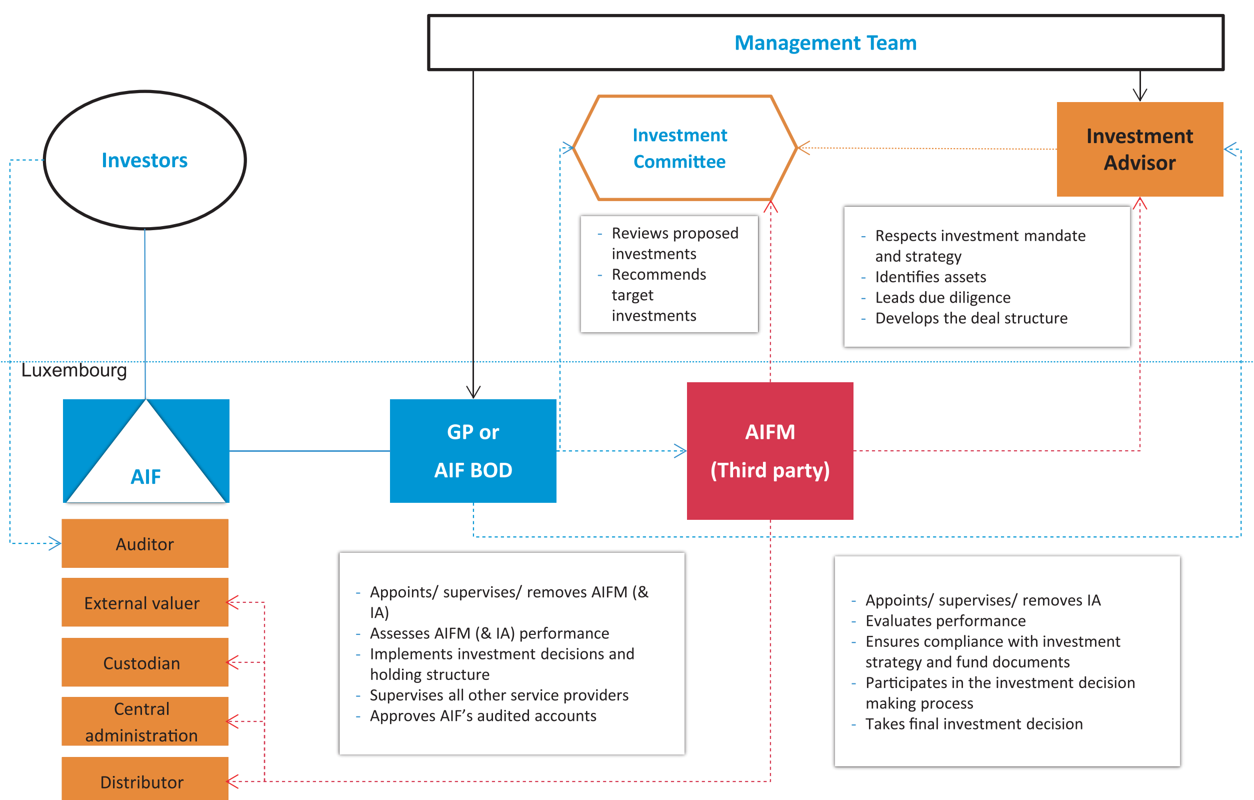
In practice, this means that the sponsor has a less influential role in the investment decision-making process at the level of the AIF, unless it strengthens its position on the AIF's board itself and the board reserves a right to appoint and remove the investment adviser, as well as to sign off on or veto all investment/divestment propositions and/or to fully implement the investments.

The sponsor can also choose to set up investment committees between the investment adviser, the independent AIFM and the AIF's Board, in order to make sure that its own board representatives are involved in the decision- making process. However, the AIFM must make sure its role is not reduced to "rubber stamping" the investment adviser's advice and recommendations.



3. Conditions for the delegation or the outsourcing of AIFM functions

Before any delegation (or sub-delegation) agreement is put in place, a Luxembourg AIFM must make sure that it provides detailed information on such arrangements to the CSSF for each fund it manages. Additionally, considerations with respect to the delegation must be included in its business continuity plan. It must perform and document a due diligence on the delegate and also identify operational risks deriving from delegation.

Any delegation agreement with the delegate must be in writing and the prospectus of the funds managed should list the specific functions which the AIFM has been authorised to delegate, as well as the identity of the entity to which the investment management function has been delegated. The AIFM and the delegate must put in place control arrangements allowing the manager's conducting officers to access the data relating to the delegated functions.

The AIFM's position in the contractual relationship with the delegate should be characterised by flexibility: the AIFM should have the right to give additional instructions to the delegate at any time and, if the interests of the investors require it, the AIFM must be entitled to withdraw the mandate with immediate effect and terminate the delegation arrangement.
The monitoring of delegated activities cannot itself be delegated under any circumstances. The AIFM must always retain the power to direct and control delegated functions. There are functions that cannot be delegated by an AIFM, such as internal control functions, IT control infrastructure, risk assessment, compliance functions, key management functions and sector-specific functions. There are other functions that, if delegated, should not be deemed to constitute a delegation of AIFM functions. These

[2] As a matter of fact, given that there are multiple facets of the investment management activities, they can be broken down and delegated only partly.
[3] In the EU it would be a MiFID firm authorized to provide investment management. When portfolio management is delegated to an entity outside the EU, in addition to the conditions listed, there must be a written cooperation agreement between the CSSF and the supervisory authority of the home state of the delegate, which would enable the CSSF to carry out inspections and inquiries and to enforce sanctions in case of breaches. The CSSF signed over 40 memos of understanding at the time of writing.

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are the administrative or technical functions assisting the management tasks (procurement of basic services and products, buying standard software off-the-shelf, reliance on software providers for ad-hoc operational assistance in relation to such systems, provision of human resources support).

By principle, all of the above conditions shall also apply under the outsourcing model, even if in the outsourcing case the AIFM remains fully in charge of the investment decisions and relies on the subcontractor for advice purposes only, thus reducing the risk for the subcontractor to negatively impact the investors. Therefore, the condition allowing the AIFM to withdraw from the contract with immediate effect is of less importance in that model.

4. No letter-box entity

The difficulty faced by a newly-formed Luxembourg AIFM belonging to an asset manager's group is to safeguard and consolidate its position, avoiding becoming a letter-box entity, and therefore no longer considered to be the manager of the AIF. In order to avoid this, the Luxembourg AIFM must have the resources and expertise to supervise the delegated task(s) and to manage the associated risks. It must maintain, in Luxembourg, the power to take decisions in key areas falling under senior management responsibility, such as the implementation of the general investment policy and investment strategies.

This translates into ensuring appropriate presence of executive board members and senior managers in Luxembourg, where they should effectively carry out their responsibilities and dedicate sufficient time to their duties. Extrapolating from ESMA's opinion, it appears that the key executives & senior managers of a Luxembourg authorised AIFM should be employed and present in Luxembourg, and work there to a degree proportionate to their role. In the opinion, ESMA calls the EU authorities to reject an authorisation request from a UK firm when all the substantial activities and functions of the AIFM are performed outside the EU borders.

The AIFM must also maintain and protect its contractual rights to inquire, inspect, and have access or give instructions to its delegates. These rights may be viewed, on the other hand, as an overstepping intrusion for a portfolio manager who has appointed an independent AIFM which has delegated the portfolio management function back to said manager.

Finally, the delegation of investment management functions should not be done to such extent as to exceed the functions performed by the AIFM itself.

Again, the same principles should apply to the outsourcing model since the CSSF should scrutinise all the outsourcing arrangements in the assessment process of the AIFM's request for authorisation. This is apparent from the recent ESMA opinion, where the latter instructs the national competent authorities to make no distinction between delegation and outsourcing.

Conclusion

A delegation arrangement, as opposed to the provision of investment advice on the basis of an outsourcing agreement, is likely to strengthen the sponsor's position when making the investment decisions for an AIF. On the other hand, it also subjects the sponsor or its affiliate to a greater amount of scrutiny from the AIFM and from its supervisory authority. When the delegate and the AIFM are part of the same group, they would need to ensure that the delegated functions, on one hand, and the resources available to the AIFM, on the other hand, ensure a proper level of substance and supervision capacity for the AIFM, so that it doesn't become a letter-box entity. An outsourcing arrangement between a sponsor and a related AIFM would demand an even greater level of resources for the AIFM, which must demonstrate not only its ability to adequately supervise the subcontractor, but also to make investment decisions for the AIFs.

Either way, asset managers intending to have boots on the ground in Luxembourg must make a strategic choice. However, the diversity of options available and the refinement of the contractual arrangements that may be set up should allow each and every one to find the perfect fit.

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ANTI-TAX AVOIDANCE DIRECTIVE 2 FORMALLY ADOPTED

OUR INSIGHTS AT A GLANCE

- On 29 May 2017, the EU Council formally adopted the proposal for an EU Directive amending the Anti-Tax Avoidance Directive, replacing measures dealing with hybrid mismatches and extending their scope to transactions with third countries. This amended directive is referred to as ATAD 2.
- A very broad range of hybrid mismatch situations are identified and a number of mechanisms to deal with the mismatches have been detailed.
- In terms of application, ATAD 2 states that the rules provided therein should only apply to "deductible payments". Hence, unless otherwise stated, the rules only apply to payments. The rules would not apply, for example, to provisions recorded in relation to financing instruments.
- EU Member States will have until 31 December 2019 to transpose ATAD 2 into their national laws and regulations which need to enter into force as from 1 January 2020 (apart from the measure on "reverse hybrid mismatches" which has to be implemented by 1 January 2022).

On 29 May 2017, the EU Council formally adopted the proposal for an EU Directive amending the Anti-Tax Avoidance Directive, "ATAD". The formal adoption follows the agreement reached on 21 February 2017 by the EU Finance Ministers on the proposal. While the ATAD already included measures dealing with hybrid mismatches in an EU context, the new directive, "ATAD 2", replaces these rules and extends their scope to transactions involving third countries. In this article, we outline the hybrid mismatches targeted by the directive, the mechanisms that should serve to avoid mismatch outcomes and the areas where ATAD 2 should have no impact.

ATAD 2 follows the recommendations of the OECD in regard to Base Erosion and Profit Shifting (BEPS) Action 2 (Hybrid mismatch arrangements) and covers a number of hybrid mismatches such as financial instrument mismatches, hybrid entity mismatches, reverse hybrid mismatches and permanent establishment mismatches.

In general, a hybrid mismatch structure is a structure where a financial instrument, an entity or a permanent establishment is treated differently for tax purposes in two different jurisdictions. Hybrid mismatches may lead to situations in which (i) a payment is deducted in two jurisdictions, (ii) a payment is deductible in one jurisdiction and not taxed in the other jurisdiction or (iii) to a situation in which income is not taxed at all (in accordance with the domestic tax laws of the jurisdictions involved).

In the case of hybrid mismatches with a third state, ATAD 2 places the responsibility to neutralise the effects of the hybrid mismatch on the EU Members States. EU Member States will therefore either have to deny the deduction of payments, or include income that would otherwise not be taxed in the third state.

Hybrid mismatches covered by ATAD 2

With its rather broad scope, ATAD 2 addresses the following types of hybrid mismatch situations:

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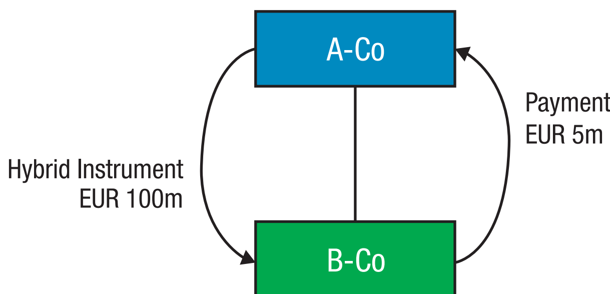
- ***Hybrid mismatches that result from payments under a financial instrument;***

Example: Hybrid financing instrument mismatch

A company resident in State A (A-Co) finances its subsidiary resident in State B (B-Co) with a EUR 100m financing instrument that is treated as equity in State A, whereas the instrument is treated as debt in State B.

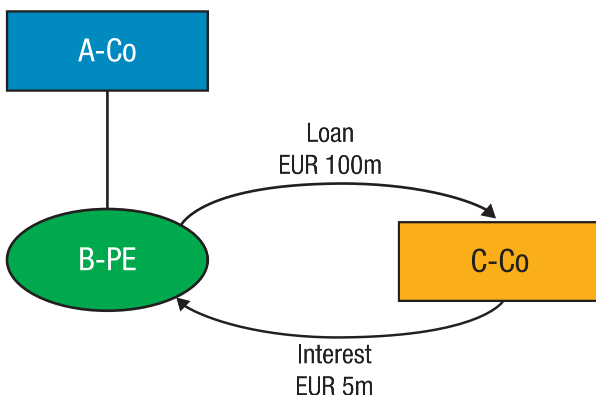


At the level of B-Co, the interest payments of EUR 5m are tax deductible, whereas at the level of A-Co the dividend income benefits from a tax exemption.

- ***Hybrid mismatches that are a consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment (PE), including situations where payments made to a disregarded PE are not taxed at the level of the head office;***

Example: Hybrid PE mismatch leading to a deduction without inclusion

A company resident in State A (A-Co) performs financing activities through a PE situated in State B (B-PE). Although the PE is recognised under the domestic tax law of State A and the applicable tax treaty concluded between State A and State B, under the domestic tax law of State B the PE of A-Co is not recognised for tax purposes. A-Co grants a loan of EUR 100m via B-PE to C-Co, an associated enterprise resident in State C.

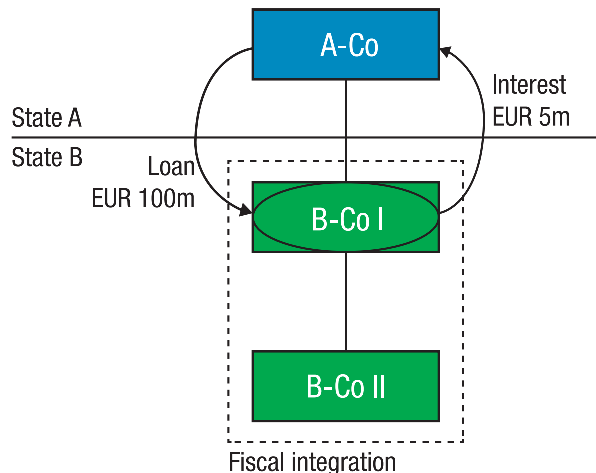


While the interest payments are deductible at the level of C-Co, State B does not tax the interest income as no PE is recognized under domestic tax law of State B. At the same time, State A exempts the income realised through B-PE in accordance with the applicable tax treaty. Hence, the income is tax deductible in State B and neither taxable nor tax exempt, respectively, in State A and State B.

- ***Hybrid mismatches that result from payments made by a hybrid entity to its owner or deemed payments between the head office and PE or between two or more PEs;***

Example: Hybrid entity mismatch leading to a deduction without inclusion

A company resident in State A (A-Co) finances its subsidiary in State B (B-Co I) with a loan of EUR 100m. While B-Co I is treated as a transparent entity from the perspective of State A, under the domestic tax law of State B, B-Co I is treated as an opaque entity. B-Co I forms a fiscal unity with B-Co II, a subsidiary resident in State B.



While the interest payments are deductible in State B, reducing the taxable income of B-Co I and the fiscal unity, at the level of A-Co the interest payments are disregarded for tax purposes since such transactions are disregarded between a transparent entity and the owners thereof.

- ***Double deduction outcomes resulting from payments made by a hybrid entity or PE.***

Example: Hybrid entity mismatch leading to a double deduction

A company resident in State A (A-Co) has a subsidiary in State B (B-Co I). B-Co I receives funding from a third party. In this

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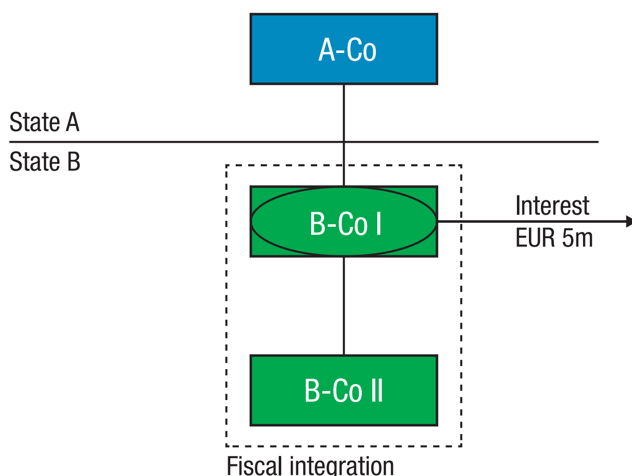
regard, B-Co I pays interest of EUR 5m. While B-Co I is treated as a transparent entity from the perspective of State A, under the domestic tax law of State B, B-Co I is treated as an opaque entity. B-Co I forms a fiscal unity with B-Co II a subsidiary resident in State B.



In this case, the interest payments are deductible at the level of B-Co I and A-Co, resulting in a double deduction due to the hybrid entity classification.

Mechanism for tackling mismatch outcomes

ATAD 2 provides for the following mechanisms to tackle mismatch outcomes:

- ***Double deductions***

Where a hybrid mismatch results in a double deduction, the deduction shall be denied in the Member State that is the investor jurisdiction.

As a secondary measure, ATAD 2 provides that in case the deduction is not denied in the investor jurisdiction, the deduction shall be denied in the Member State that is the payer jurisdiction.

- ***Deduction without inclusion***

Where a hybrid mismatch results in a deduction without inclusion, it is stated that the deduction shall be denied in the Member State that is the payer jurisdiction.

As a secondary measure, the directive provides that if the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome shall be included in the income in the Member State that is the payee jurisdiction.

With regard to the latter rule, Member States have the option to not apply the secondary rule to certain types of hybrid mismatches.

- ***Reverse hybrid mismatches***

ATAD 2 also provides for a rule that targets so-called reverse hybrid mismatches. When an entity is established in a Member State and treated as transparent for tax purposes, whereas at the level of the non-resident owners of the entity, the latter is treated as opaque, the income might benefit from double non-taxation.

Here, the directive sets a threshold of at least 50% of the voting rights, capital interests or rights to a share of profit for the rule to apply. It is interesting to note that in other situations, the ATAD rules apply when a shareholding relationship of at least 25% exists. Hence, the scope of the reverse hybrid rules is a bit more restrictive when it comes to the shareholding threshold.

In these circumstances, the hybrid entity shall be regarded as a resident of the Member State and taxed to the extent the income is not taxed otherwise under the laws of the Member State or any other jurisdiction.

- ***Tax residency mismatches***

Last but not least, ATAD 2 provides for a rule that deals with situations in which an entity is deemed to be resident in two or more jurisdictions and expenses are deductible in both jurisdictions.

Here, the directive states that a Member State involved shall deny the deduction to the extent that the other jurisdiction allows the duplicate deduction to be set-off against income (which is not classified as dual-inclusion income).

In cases where both jurisdictions are EU Member States, the Member State where the taxpayer is deemed “not” to be resident in accordance with an applicable tax treaty shall deny the deduction.

Where ATAD 2 should have no impact

It is interesting to note that the guidance provided in ATAD 2 clarifies a number of issues in relation to the scope and the application of the rules on hybrid mismatches.

ATAD 2 states that the rules provided therein should only apply to “deductible payments”. Hence, unless otherwise stated, the rules only apply to payments. The rules would not apply, for example, to provisions recorded in relation to financing instruments. Furthermore, the payment needs to be deductible, which therefore excludes non-deductible payments from the scope of ATAD 2.

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Moreover, as jurisdictions use different tax periods and have different rules for recognising when items of income or expenses have been derived or incurred, ATAD 2 stresses that these timing differences should generally not give rise to hybrid mismatches as long as the income is included within a reasonable period of time.

According to the Directive, a payment under a financial instrument shall be treated as included in income within a reasonable period of time when:

- the payment is included by the jurisdiction of the payee in a tax period that commences within 12 months of the end of the payer's tax period; or
- it is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future period and the terms of the payment are consistent with the arm's length principle. Thus, when a timing difference exceeds the aforementioned 12-month period, taxpayers should be free to evidence that the payment will be included in a future period.

ATAD 2 further confirms that any adjustments required in accordance with the Directive should in principle not affect the allocation of taxing rights between Contracting States under applicable tax treaties. This statement acknowledges that treaty law is generally superior to the domestic tax laws of the Contracting States.

In addition, the guidance included in the directive confirms that transfer pricing adjustments should not fall within the scope of a hybrid mismatch.

Last but not least, ATAD 2 provides for a carve-out from the rules when it comes to hybrid regulatory capital. This is of particular importance for the banking sector which is required to comply with certain solvency criteria. However, this carve-out should be limited in time until 31 December 2022. With regard to financial traders, a delimited approach is followed in line with that which is followed by the OECD.

Timing aspects

EU Member States will have until 31 December 2019 to transpose ATAD 2 into their national laws and regulations which need to enter into force as from 1 January 2020 (apart from the measure on "reverse hybrid mismatches" which has to be implemented by 1 January 2022). This is a longer timeline than originally foreseen for the rules on hybrid mismatches in an EU context (i.e. ATAD, in its first incarnation, had required an implementation by 31 December 2018).

Conclusion

ATAD 2 replaces the rules on hybrid mismatches provided in the ATAD, postpones their implementation into the domestic tax laws of EU Member States by one year and extends the rules to third country mismatches. The extension to third countries has been criticised as being damaging to EU competitiveness, however the EU Member States have decided to proceed nonetheless.

Given the extreme complexity of these rules including hybrid mismatches, reverse hybrid mismatches and so-called imported hybrid mismatches (which may occur at some level of group structure), the application of these anti-mismatch provisions will be a very intricate and time-consuming exercise on the part of the taxpayers and the tax administrations. One can hope that the Luxembourg legislator and tax authorities will not seek to go beyond the rules provided in ATAD 2, which are already very broad and complex.

Looking on the bright side of the Directive, it is positive that the guidance provided in the Directive clarifies many previously uncertain points in relation to the scope and the application of these rules.

Although ATAD and ATAD 2 will only be implemented as from 2019 with a number of options available for EU Member States as to the date of entry into force of the tax measures, taxpayers should already begin to assess the potential impact of these changes on existing investment structures and closely monitor the legislative process around the implementation of the new rules.

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DISPUTE RESOLUTION AT EU LEVEL: AGREEMENT ON DIRECTIVE PROPOSAL

OUR INSIGHTS AT A GLANCE

- On 23 May 2017, the EU Economic and Financial Council reached an agreement on the proposal of the Council Directive on double taxation dispute resolution mechanisms in the European Union, according to which Member States will have to efficiently resolve situations of double taxation
- The Directive Proposal sets up a 3-step process: complaint by the taxpayer, mutual agreement procedure (MAP) and dispute resolution by the Advisory Commission. The final decision taken by the Competent Authorities to solve double taxation should be made within an average period of 5 to 7 years.
- According to the Directive Proposal, the submission of a complaint does not preclude taxpayers to use the remedies available under domestic law but shall put an end to any other ongoing mutual agreement procedure or dispute resolution procedure under a DTT or convention that is being interpreted or applied in relation to the relevant question of dispute
- Once the European Parliament has given its opinion on the Directive Proposal and the European Council has given its final vote, the Directive should apply to any complaint submitted from 1 July 2019 onwards with respect to questions related to a tax year starting on or after 1 January 2018

Assessments of the current double taxation dispute resolution mechanisms provided for in domestic laws, Double Tax Treaties ("DTT") and the EU Arbitration Convention have made clear that these mechanisms were inefficient for resolving double taxation issues and needed to be improved, in particular as regards to access, length and effectiveness of the procedures.

On 23 May 2017, the EU Economic and Financial Council reached an agreement on the proposal of the Council Directive on double taxation dispute resolution mechanisms in the European Union (the "Directive Proposal"), according to which Member States will have to efficiently resolve situations of double taxation. However, as we explain below, the process put in place by the Directive may still be too long in order to really be efficient. In addition, some of its provisions remain unclear.

Scope of the Directive Proposal

While the initial proposal aimed to broadly cover disputes between Member States on how to eliminate any double taxation of income from business whether or not covered by a DTT, the Directive Proposal, as adopted, lays down rules on a mechanism to resolve disputes when these arise from the interpretation and application of agreements and conventions that provide for the elimination of double taxation of income and, where applicable, capital (the "Double Taxation Dispute"). For the purpose of the Directive Proposal, double taxation is defined as the taxation by two (or more) Member States of the same taxable income or capital when it gives rise to either additional tax charge, increase in tax liabilities or cancellation or reduction of losses, which could be used to offset taxable profits.

Double Taxation Dispute Resolution Mechanisms

The Directive Proposal sets up a 3-step process:

- ***Complaint by the taxpayer***

According to the Directive Proposal, any person, including an individual, that is tax resident in a Member State and whose taxation is directly affected by a Double Taxation Dispute, is entitled to submit a complaint to each of the competent tax authorities to be designated by the Member States concerned (the "Competent Authorities"). To be valid, the complaint must be submitted within a certain deadline and must contain the

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necessary information to enable each Competent Authority to understand and evaluate the taxpayer's claim. Such information should be protected under national rules protecting trade, business, industrial or professional secret or trade processes.

Once the complaint is lodged, each Competent Authority will decide on its admissibility without assessing its merits. A Competent Authority may also decide to resolve the Double Taxation Dispute on a unilateral basis without involving the other Competent Authorities. The complaint will be rejected either if there is no question of dispute, the relevant deadlines are not respected or the required information is missing. Taxpayers have the right to contest such rejection pursuant to the Directive Proposal or according to national rules.

- ***Mutual Agreement Procedure (MAP)***

Where each Competent Authority has accepted the complaint, they will attempt to resolve, by mutual agreement, the Double Taxation Dispute in accordance with the terms of the relevant DTT and the national laws. Once the Competent Authorities have reached an agreement as to how to resolve the Double Taxation Dispute, their decision is binding on the national authority and enforceable by the taxpayer. Where no agreement is reached, the taxpayer will be informed of the general reasons why the Competent Authorities could not reach an agreement and the taxpayer will be entitled to request an opinion from the Advisory Commission.

- ***Dispute resolution by the Advisory Commission (the "Commission")***

The Commission may first be required to decide on the validity of the complaint when it is rejected by at least one but not all of the Competent Authorities. If the Commission confirms the admissibility of the complaint, the MAP shall be initiated. The decision of the Commission on the acceptance of the complaint is binding on the Member States concerned.

When the Competent Authorities are not able to reach an agreement on how to resolve the Double Taxation Dispute by mutual agreement within the time limits provided for, the Commission may also be required to deliver an opinion based on the provisions of the applicable DTT or conventions as well as any applicable national rules. When issuing its opinion, the Commission has a consultative role and provided that the Competent Authorities reach an agreement, they may take a final decision which deviates from the opinion of the Commission. If they fail to reach an agreement on how to resolve the question of dispute, they shall however be bound by that opinion. The final decision taken shall be binding on the Member States concerned but, unfortunately, shall not constitute a precedent.

The Commission is composed by one or two representative(s) of each Competent Authority and by one or two independent person(s) appointed, in principle, by the Competent Authorities, at the request of the taxpayer. They shall in turn elect a chair amongst a list of independent persons of standing nominated by the Member States. An Alternative Dispute Resolution Commission or a permanent committee (Standing Committee) may be set up instead of the Advisory Commission to deliver an opinion. The Alternative Dispute Resolution Commission may differ regarding its composition and form and may apply, where appropriate, any additional dispute resolution processes or techniques than the independent opinion process in order to solve the dispute in a binding manner, including the "final offer" arbitration.

Interaction with other proceedings

According to the Directive Proposal, the submission of a complaint does not preclude taxpayers to use the remedies available under domestic law but shall put an end to any other ongoing MAP or dispute resolution procedure under a DTT or convention that is being interpreted or applied in relation to the relevant question of dispute. The benefit of final decisions taken by the Competent Authorities is nevertheless subject to the taxpayer accepting the final decision and renouncing the right to any domestic remedy.

As a result, taxpayers could run two proceedings, in parallel, at the same time and conflicting decisions could be taken at different levels. Interactions between domestic law and the Directive Proposal will be governed by Member States' domestic law and/or administrative procedures. It is nevertheless expected that national laws will include provisions for the suspension of domestic law proceedings as long as the taxation dispute resolution mechanisms under the Directive Proposal are pending. National laws will also have to rule on whether a Competent Authority will be legally bound, in the context of the MAP, by a domestic court's decision.

Timing aspects

The final decision taken by the Competent Authorities to solve double taxation should be made within an average period of 5 to 7 years from the receipt of the first notification of the action resulting in, or that will result in a Double Taxation Dispute. When exactly this timeline begins is unclear and would need to be described in more detail. In addition, such a deadline is far too long to ensure certainty and predictability in the application of tax law for businesses. A clear and shorter timeframe would be key to improving the effectiveness of the mechanisms put in place by the Directive Proposal.

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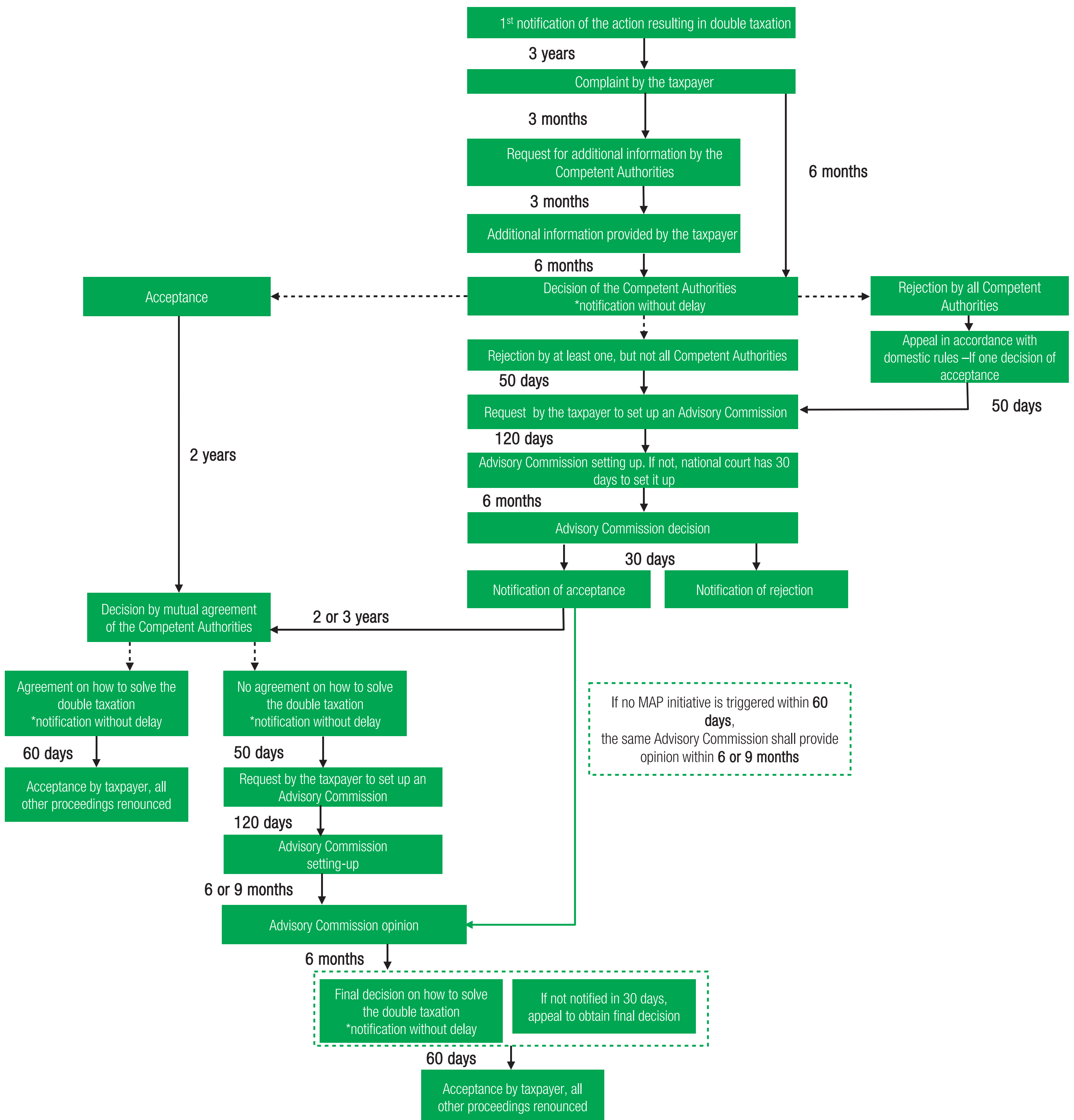

Next steps

Once the European Parliament has given its opinion on the Directive Proposal and the European Council has given its final vote, the Directive should apply to any complaint submitted from 1 July 2019 onwards with respect to questions related to a tax year starting on or after 1 January 2018. Member States will have until 30 June 2019 to implement the directive into national laws and regulations.

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LUXEMBOURG SIGNS MLI AND PRESENTS ITS APPROACH ON THE IMPLEMENTATION OF TREATY-RELATED BEPS MEASURES

OUR INSIGHTS 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.

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.

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 taxpayers while also opting for additional legal certainty through the adoption of the binding arbitration procedure, helping mitigate situations of double taxation.

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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+ 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 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 a 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.

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 favour 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 ultimately 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".

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 currently do 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.

- 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 determine whether and what provisions of a tax treaty will or will 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 that of its main competitors. Some of Luxembourg's competitors, like the UK, announced months ago that they would opt for an approach aiming at implementing only those MLI measures which are considered as 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 similar jurisdictions. In addition to the minimum

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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, 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 provision 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. Moreover, it will 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 proposed by 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. This provision determines that in the case of a company with a dual residence, the competent authorities of both Contracting States shall endeavour to define, 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 (MAP) 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. The tax authorities involved have, quite naturally, no incentive to easily give up their taxing rights. Therefore, 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 MAP 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 prove beneficial for Luxembourg resident taxpayers.

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The same is true with respect to 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 situations of double taxation. Despite similar rules having been recently introduced 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 chose 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 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 treaties 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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