

Upcoming Changes to the Tax Treatment of US Branch Structures under the US-Luxembourg Tax Treaty

By Oliver R. HOOR (left picture), Keith O'DONNELL (right picture) and Samantha SCHMITZ-MERLE, Atoz*

The United States and Luxembourg are currently negotiating about the content of a protocol to the existing tax treaty concluded between both countries (the "US-Lux Tax Treaty"). The tax treatment of US permanent establishments (PEs) of Luxembourg companies is in the focus of these negotiations. In this regard, the United States and Luxembourg announced on 22 June 2016 agreement to implement a specific change to the existing US-Luxembourg tax treaty. This article outlines the current tax treatment of US PEs and analyses the planned changes to the US-Lux Tax Treaty.

1. Tax treatment of US Branches: The Status Quo

Luxembourg companies are generally subject to corporate income tax and municipal business tax on their worldwide income, including income derived through foreign PEs. However, tax treaties concluded by Luxembourg frequently allocate an unlimited primary taxing right over profits that are attributable to a foreign PE to the host state thereof, whereas Luxembourg adopts the exemption method for the avoidance of double taxation. The tax treaty concluded between the US and Luxembourg follows this methodology.

Under US internal law, income derived by a Luxembourg company through a PE situated in the US is not in all cases taxed in the US given that foreign corporations are only subject to PE taxation in the US when they conduct a trade or business through a fixed place of business in the US and the activity in the US may not rise to the level of a "trade of business" in the US.

Therefore, to the extent the activities performed by a Luxembourg company through its US branch do not come within the scope of "trade or business" within the meaning of US tax law, the US branch may not always be subject to tax in the US. Accordingly, in practice there may be cases where a PE is considered from a Luxembourg tax perspective (and under tax treaty law), whereas no taxable presence is considered for US tax purposes.

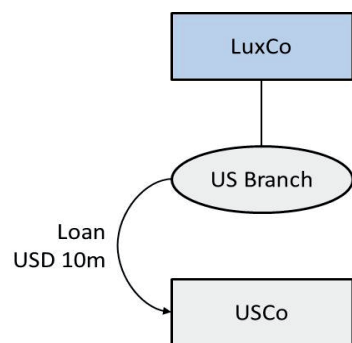
However, in accordance with international tax law, the exemption of the income in Luxembourg is not subject to the condition that the host state of the PE exercises its taxing right unless a specific provision has been included in the relevant tax treaty. It follows that Luxembourg has to exempt income derived through a foreign branch from taxation irrespective of whether the US makes use of its taxing right.¹⁾ While the primary purpose of tax treaties is the avoidance of effective double taxation, the strict allocation of taxing rights generally avoids even virtual double taxation (that is a mere "potential" or "theoretical" double taxation). Likewise, the application of the exemption method is not dependent on whether or not a PE is recognized by the treaty partner jurisdiction. This means that the existence of a PE of a Luxembourg company in a foreign jurisdiction has to be determined based on domestic tax law and tax treaty law only. The tax treatment in the foreign jurisdiction does not impact the Luxembourg analysis.

Example: A Luxembourg company with a US finance branch

A Luxembourg company ("LuxCo") performs financing activities through a branch situated in the US. More precisely, LuxCo grants a loan of USD 10m to a borrower situated in the US. The allocation of the loan to the US branch allows LuxCo, amongst others, to effectively manage the foreign exchange risks and local cash movements.

Example: A Luxembourg company with a US finance branch

A Luxembourg company ("LuxCo") performs financing activities through a branch situated in the US. More precisely, LuxCo grants a loan of USD 10m to a borrower situated in the US. The allocation of the loan to the US branch allows LuxCo, amongst others, to effectively manage the foreign exchange risks and local cash movements.



From a Luxembourg tax perspective, the branch constitutes a PE within the meaning of Section 16 of the Tax Adaptation Law and Article 5 of the US-Lux Tax Treaty. Accordingly, the US-Lux Tax Treaty allocates an unlimited primary taxing right over

profits attributable to the US Branch to the US, whereas Luxembourg applies the exemption method.

To the extent no taxable presence is considered in the US, the profits attributable to US Branch will not be taxed in the US. In these circumstances, neither the US nor Luxembourg would tax the income realized through the activities performed by the PE situated in the US.

2. The Upcoming Changes to the Tax Treaty

On 22 June 2016, the United States and Luxembourg announced agreement to changes to the US-Lux Tax Treaty that would address situations of double non-taxation in case of US branch structures. The planned changes are in line with the wording of the 2016 US Model Treaty. In addition, a draft law was submitted to the Luxembourg Parliament anticipating the upcoming amendment to the US-Lux Tax Treaty.

The aim of this amendment is to stop situations of double non-taxation resulting from different interpretations of the permanent establishment (PE) concept in Luxembourg and the US. Under the amended US-Lux Tax Treaty rules, the US will be allowed, under certain conditions, to deny tax treaty benefits and, in particular, to levy withholding tax in accordance with US tax law on interest, royalty and dividend payments deriving from US sources to a Luxembourg company if the income is not taxed in Luxembourg (because for Luxembourg tax purposes the income is attributable to a PE located in the US or a third country).

However, taking the example of a Luxembourg resident company with US source income, the denial of treaty benefits by the US will only be possible if:

- The income which is considered as attributable to the foreign PE is taxed at a combined aggregate effective tax rate which is lower than the lesser of either 15%, or 60% of the Luxembourg statutory rate; or
- Under Luxembourg tax law, the income is attributable to a PE which is located in a third country that does not have a comprehensive tax treaty with the US, unless Luxembourg includes the PE income into the taxable basis of the Luxembourg head office.

Even where one of the above conditions applies, the competent authorities may still decide via mutual agreement that treaty benefits should be granted. A possible justification would be, for example, the existence of tax losses. According to the draft law, the changes to the applicable tax treaty will apply retroactively as from the publication of the Luxembourg law in the Official Gazette, although the relevant protocol is still in negotiation (this protocol will also include additional provisions).

This means that if the Luxembourg legislative process can be finalised this summer, the change to the US-Lux Tax Treaty (by means of a protocol) will apply retroactively as from then, with no regard to when the protocol is finally signed.

The protocol will, however, not have any impact on the tax treatment of US branches of Luxembourg companies to the extent income is derived from third states. Hence, in these cases a different interpretation of the concept of permanent establishment under US and Luxembourg tax law may still create anomalies.

Conclusions

Taxpayers that have US branches of Luxembourg companies in their groups should already be aware of the discussions about the US-Luxembourg tax treaty and the potential content of the protocol. However, the way the amendment is implemented is somewhat unusual and debateable from a legal perspective.

In the US, protocols amending existing tax treaties only enter into force when the agreements have gone through the advice and consent procedures of the US Senate and the President signs the instruments of ratification. Currently, due to the partisan nature of tensions in the US political system, ratification of tax treaties and protocols is at best delayed, if not completely blocked.

Likewise, in Luxembourg a protocol must run through a ratification process before it can become effective. Hence, it is unusual that the protocol will in this case be implemented with retroactive effect. Thus, there will be an interim period between publication in Luxembourg and US ratification (likely several years later) where the protocol is not legally effective but where its effects may need to be applied retrospectively following US ratification, potentially giving rise to some administrative issues in assessing companies.

Nevertheless, it should be noted that this unusual procedure was driven by a combination of US political pressure (willingness to close a loophole quickly) and US political limitations (inability to ratify a protocol expeditiously). The solution reflects a pragmatic, and dare we say creative, approach by the Luxembourg authorities to reconcile these conflicting imperatives.

Given that some US branch structures will soon become inefficient, taxpayers need to develop a strategy to manage their business activities in a different fashion. Potential restructuring will have to be tailored to each specific set-up with careful consideration of the tax requirements in all jurisdictions concerned.

* Oliver R. HOOR is a Tax Partner (Expert Comptable, Steuerberater), Keith O'DONNELL is the Managing Partner and Samantha SCHMITZ-MERLE is a Director with ATOZ Tax Advisers (Taxand Luxembourg).

The authors may be contacted at: oliver.hoor@atoz.lu, keith.odonnell@atoz.lu, samantha.merle@atoz.lu

www.atoz.lu

¹⁾ The applicable tax treaty provides for an unconditional exemption of profits attributable to a branch in the US. Thus, Luxembourg has no taxing authority over such profits.

Inauguration des nouveaux bâtiments de BNP Paribas au Kirchberg

Le 4 juillet 2016, le Groupe BNP Paribas à Luxembourg a officiellement inauguré ses nouveaux bâtiments au Kirchberg en présence du Premier ministre Xavier Bettel, du Vice-Premier ministre et ministre de l'Economie Etienne Schneider, du ministre des Finances Pierre Gramegna et de la bourgmestre de la Ville de Luxembourg, Lydie Polfer.

Le nouveau Centre Bancaire Kirchberg du Groupe BNP Paribas au Luxembourg a une surface totale de 99.000 m² et est composé de trois bâtiments. Outre le bâtiment existant du siège social de BGL BNP Paribas, il comprend les deux nouveaux immeubles : un bâtiment haut de 6 étages situé sur l'avenue J.F. Kennedy, et un bâtiment de 14 étages situé du côté de la rue Edward Steichen. Les deux bâtiments reposent sur un socle commun reliant l'avenue J.F. Kennedy et la rue E. Steichen et comportent des liaisons avec le bâtiment du siège social. Le site héberge dorénavant près de 3500 collaborateurs.

Carlo Thill, responsable Pays du Groupe BNP Paribas à Luxembourg, explique : «Lors du début des travaux en mars 2013, le Groupe BNP Paribas



De gauche à droite : Carlo Thill, responsable Pays du Groupe BNP Paribas à Luxembourg et président du Comité de direction de BGL BNP Paribas, Lydie Polfer, bourgmestre de la Ville de Luxembourg, Xavier Bettel, Premier ministre, Etienne Schneider, Vice-Premier ministre, ministre de l'Economie, Pierre Gramegna, ministre des Finances, Etienne Reuter, président du Conseil d'administration de BGL BNP Paribas

au Luxembourg comptait plusieurs bâtiments centraux, sans compter les quelque 40 agences du réseau de BGL BNP Paribas. L'objectif du projet de construction était de rassembler les collaborateurs

de la plupart des entités du Groupe sur le site du Kirchberg afin de renforcer la coopération et les synergies. Ce projet d'envergure confirme l'ancrage solide du Groupe BNP Paribas dans l'économie

luxembourgeoise et témoigne de l'engagement du Groupe en faveur du développement de la place financière luxembourgeoise.»

Les bâtiments ont été conçus par M3 Architectes en collaboration avec le Bureau d'Etudes Goblet Lavandier. Les espaces verts joignant les trois bâtiments bénéficient d'un aménagement paysager dans la prolongation des jardins conçus par le paysagiste Jacques Wirtz pour le siège social. Une cinquantaine d'entreprises ont été impliquées dans la construction du nouveau site, originaires principalement du Luxembourg et de la Grande Région.

Dans la conception du projet, le Groupe BNP Paribas au Luxembourg a mis l'accent sur le respect de l'environnement. Une attention particulière a été accordée aux technologies écoresponsables ainsi qu'à une consommation minimale d'énergie et de ressources naturelles. Le Groupe a en effet pour objectif une triple certification environnementale à dimension européenne (DGNB en Allemagne, BREEAM au Royaume-Uni, HQE en France).

Le projet a déjà acquis un certificat «HQE Exceptionnel» en phase réalisation, ce qui confirme que le bâtiment répond aux exigences d'un niveau de performance défini dans le schéma technique de certification 2012 pour chacun des quatre thèmes suivants : énergie, environnement, santé, confort.