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Luxembourg newsflash

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Cross-border business tax: October news

This newsflash summarises three of the most important OECD and EU tax developments released in October 2023, which could potentially impact taxpayers with operations in Luxembourg:

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1. OECD multilateral convention implementing Pillar 2 subject to tax rule open for signature

On 3 October 2023, the OECD/G20 Inclusive Framework on BEPS announced it had concluded negotiations on a multilateral convention ("MLC") implementing the Pillar 2 subject to tax rule ("STTR"). The STTR is part of the 2-Pillar solution to address tax challenges from the digitalisation of the economy and complements the Global Anti-Base Erosion rules ("GloBE rules") that provide for a global minimum effective taxation of 15% for in-scope multinational groups (read more details on the GloBE rules here_ and here_).

The STTR has been developed as a treaty-based rule to help developing countries protect their tax base by allowing a source jurisdiction which has ceded its taxing rights (totally or partially) on certain outbound intra-group payments under a tax treaty, to recover some of those rights where the income concerned is taxed in the payee's jurisdiction at a rate below 9%. The rule broadly allows (but does not oblige) the source jurisdiction to tax the gross amount of covered income at a specified rate, equal to the difference between 9% and the tax rate applied in the residence jurisdiction.

The MLC is now open for signature by the relevant jurisdictions. More than 70 developing countries are entitled to request inclusion of the STTR in their tax treaties with treaty partners that apply corporate income tax rates below 9% to covered payments. Treaty partners who are members of the Inclusive Framework have committed to apply the STTR when requested to do so. It appears that jurisdictions that are not developing countries may also request implementation of the STTR in their tax treaties.

Interaction with GloBE rules

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The STTR will apply before the GloBE rules. The STTR will be taken into account for the computation of the GloBE effective tax rate and thus the potential application of the qualified domestic minimum top-up tax ("QDMDT"), the income inclusion rule ("IIR") and the undertaxed payments rule ("UTPR").

The STTR's scope differs from that of the GloBE rules. In particular, the STTR is not limited to members of multinational groups meeting the revenue threshold applicable for the purposes of the GloBE rules. In addition, specific exclusions and thresholds apply, as described below.

Personal scope

The STTR only applies to covered payments between connected parties, which broadly means a control relationship or the direct or indirect holding by one person of more than 50% of the beneficial interest or the aggregate vote and value in the other person.

However, the STTR will not apply to payments made to a list of excluded recipients, including individuals, non-profit organisations, States and certain government entities, pension funds, investment funds (subject to certain conditions), and certain entities wholly-owned or virtually wholly-owned by an excluded recipient.

Covered payments

The STTR will apply to seven categories of income ("covered income"): (i) interest, (ii) royalties, (iii) payments made in consideration for the use of, or the right to use, distribution rights in respect of a product or service, (iv) insurance and reinsurance premiums, (v) fees to provide a financial guarantee, or other financing fees, (vi) rent or any other payment for the use, or the right to use, industrial, commercial or scientific equipment, and (vii) any income received in consideration for the provision of services.

However, the STTR will not apply if the gross amount of covered income (except for interest or royalties) does not exceed the recipient's costs for the activity giving rise to the income + 8.5% ("mark-up threshold test").

Materiality threshold

The STTR will not apply where the total gross amount of covered income paid by persons in a source jurisdiction to a connected payee in the residence jurisdiction is less than EUR 1 million in the fiscal year concerned. This threshold is reduced to EUR 250,000 in the fiscal year concerned where one of the contracting States has a gross domestic product of less than EUR 40 billion on the date of the entry into effect of the STTR.

Tax rate test

The tax rate considered in the payee jurisdiction is the statutory rate of tax applicable to the relevant covered income. Where the payee benefits from a preferential adjustment on this income (such as a full or partial exemption, or a deduction from the tax base), the rate will be determined after consideration of this preferential adjustment.

An anti-avoidance rule will apply to this test, targeting particular abuses to escape the STTR, such as back-to-back payment arrangements designed to sever the connection between a payer and a connected payee or to interpose a connected person subject to a tax rate of 9% or more.

STTR collection

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The STTR will be collected as an ex-post annual charge, meaning that the additional tax that the source jurisdiction will be able to levy on covered income by application of the STTR will not be levied at the time the income is paid. Instead, it will be collected after the end of the fiscal year, i.e. once all the relevant information for application of the STTR is known (e.g. whether the mark-up or materiality thresholds are met).

The ex-post annual charge will operate by way of taxpayer self-assessment and it remains to be seen how the STTR will be implemented in practice. In that respect, the MLC merely states that the contracting States' competent authorities may settle the STTR's mode of application by mutual agreement.

Interaction with domestic law and other treaty provisions

The STTR sets a ceiling on the source jurisdiction's taxing rights but does not require the source jurisdiction to exercise that taxing right in full or to tax the gross amount of the covered income. This will depend on the source jurisdiction's domestic tax laws.

In addition, the STTR's purpose is not to reallocate taxing rights between the source jurisdiction and the residence jurisdiction, but to allow the source jurisdiction to tax (capped at a specified tax rate) covered income that is subject to a low tax rate in the payee's jurisdiction of residence. As a result, the STTR will generally not trigger an obligation for the residence jurisdiction to apply the exemption method or provide a tax credit for the tax paid in the source jurisdiction.

Next steps

The MLC opened for signature by the affected members of the OECD/G20 Inclusive Framework on BEPS on 2 October 2023. When a State signs the MLC, it must notify the Depositary (the secretary-general of the OECD) of the double tax treaties to be covered by the MLC. A double tax treaty will become a "covered tax agreement" once notified by both contracting States and the STTR will be included as an annex to all covered tax agreements, without further amendments. The MLC includes four additional annexes that will be added to covered tax agreements in certain cases.

Signature of the MLC must be followed by ratification, acceptance or approval, depending on each State's domestic legal requirements.

The MLC will generally enter into force three months after the deposit of the second instrument of ratification, acceptance or approval. The STTR provisions will generally have effect for a covered tax agreement from the first day of a fiscal year following a period of 6 months starting from the latest of the dates of entry into force of the MLC for each contracting State to the covered tax agreement.

Concluding remarks

The full list of developing countries entitled to request inclusion of the STTR in their tax treaties is not entirely clear, although there are more than 70. In addition, the actual number of covered tax agreements may be limited, since the STTR provisions will not apply to jurisdictions with nominal tax rates of at least 9% applying to covered income.

The impact of the STTR on Luxembourg companies will have to be reviewed on a case-by-case basis, considering inter alia (i) that taxable profits are, as a general rule, subject to Luxembourg corporate taxes at a rate of approximately 25%, without the opportunity to apply any preferential adjustment to covered income (save in specific cases, such as the Luxembourg IP box regime), (ii) the targeted anti-avoidance rule for certain back-to-back arrangements, and (iii) cases involving Luxembourg investment funds that may be excluded from the scope of the STTR to the extent they come within the definition of excluded entities.

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The impact of the STTR provisions must, however, be considered more broadly and taxpayers should monitor the implementation of the STTR in every relevant tax treaty involving developing countries.

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2. DAC 8 adopted by the Council of the EU

On 17 October 2023, the Council of the EU adopted a directive amending EU rules on administrative cooperation in the area of taxation ("DAC 8").

The amendments mainly extend the scope of **mandatory automatic exchange of information between EU tax authorities** under Directive 2011/16/EU ("DAC") to cover information on:

(i) Transactions involving **crypto-assets and e-money** (transfers and exchanges), which will have to be reported by EU-based and non-EU based crypto-asset service providers, whether they are regulated or not. Crypto-assets are defined broadly and include crypto-assets that have been issued in a decentralised manner, as well as stablecoins, including e-money tokens and certain non-fungible tokens (NFTs). DAC 8 includes provisions on due diligence of crypto-asset users to determine whether they are reportable persons, which will exclude users not resident in a Member State and identify excluded persons (e.g. government entities, international organisations, central banks and financial institutions).

(ii) **Advance cross-border rulings involving the tax affairs of individuals** which are issued, amended or renewed after 1 January 2026 and where (i) the amount of the transaction or series of transactions covered by the ruling exceeds EUR 1,500,000 (or the equivalent in any other currency), if such amount is referred to in the ruling, or (ii) the ruling determines whether a person is or is not resident for tax purposes in the Member State issuing the ruling.

(iii) **Income derived from non-custodial dividends** (i.e. dividends or other income treated as dividends in the payer's Member State which are paid or credited to an account other than a custodial account), other than dividends exempt from corporate income tax pursuant to the EU Parent Subsidiary Directive.

Other provisions reinforce the effectiveness of the DAC, including the collection, reporting and sharing of individuals and entities' TINs.

Finally, Member States will have to:
- Put in place an effective mechanism to ensure the use of information acquired through the reporting or exchange of information under the DAC.
- Implement penalties which are effective, proportionate and dissuasive.
- Implement most of the new rules by the end of 2025, to be applicable from 1 January 2026.

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3. EU Blacklist: Antigua and Barbuda, Belize and Seychelles added while British Virgin Islands, Costa Rica and Marshall Islands removed

On 17 October 2023, the Council of the EU revised_ the EU list of non-cooperative jurisdictions for tax purposes ("EU blacklist") by adding Antigua and Barbuda, Belize and Seychelles and removing British Virgin Islands, Costa Rica and Marshall Islands.

Following this update, the EU blacklist comprises 16 jurisdictions:

- American Samoa
- Antigua and Barbuda
- Anguilla
- Bahamas
- Belize
- Fiji
- Guam
- Palau
- Panama
- Russia
- Samoa
- Seychelles
- Trinidad and Tobago
- Turks and Caicos Islands
- US Virgin Islands
- Vanuatu

The Council raised concerns about the lack of transparency by Antigua and Barbuda, Belize and Seychelles regarding the exchange of tax information upon request.

The revised list becomes official upon publication in the Official Journal of the EU. The next revision is due in February 2024.

For more information on the impact on Luxembourg investment structures, see our previous newsflashes here_ and here_.

In addition, once the public country-by-country reporting measures apply, i.e. for financial years starting on or after 22 June 2024, Luxembourg taxpayers within the scope of public country-by-country reporting will be required to produce, publish and make accessible a report on corporate income tax information including a list of all subsidiaries included in the consolidated accounts of the ultimate parent undertaking that are established in tax jurisdictions listed on the EU blacklist or the EU grey list. For further information on Luxembourg's public country-by-country reporting provisions, see our previous newsflash here_.

EU taxpayers carrying out transactions with related entities located in jurisdictions on the EU blacklist should assess the impact of the revised list on their operations, bearing in mind that this list is updated regularly and must be closely monitored.

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How can we help?

The Tax Law partners and your usual contacts at Arendt & Medernach are at your disposal to further assess and advise on the impact of the above tax developments on your operations.

Your contacts:

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This document is intended to provide you with general information on the subjects mentioned above.
Under no circumstances shall it constitute legal advice or replace adequate consultation with a legal advisor.