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Recent BEPS related legislation/guidance impacting Luxembourg

Recently a set of BEPS related draft legislation/guidance has been published: (i) on 21 June 2016, the Council of the European Union ("**EU**") agreed on the draft Anti-Tax Avoidance Directive ("**ATAD**"), (ii) on 22 June 2016 a bill of law regarding the adoption of a Protocol amending the US/Luxembourg double tax treaty ("**Protocol**") was filed with the Luxembourg Parliament and (iii) on 29 June 2016, the OECD released new guidance on the implementation of the Country-by-Country ("**CbC**") Reporting. For your convenience, we have summarised hereafter the key elements of the ATAD, the Protocol and the guidance on the CbC Reporting.

Anti-Tax Avoidance Directive

The ATAD is part of the broader anti-tax avoidance package announced by the EU Commission on 28 January 2016 which consists in (i) a recommendation on implementation of measures against tax treaty abuse, (ii) a revision of the administrative cooperation directive, (iii) a communication on an external strategy for effective taxation and (iv) the ATAD. The anti-tax avoidance package is based on the 2015 OECD base erosion and profit shifting ("**BEPS**") Report and aims to prevent aggressive tax planning, to increase transparency and to create fairer environment for businesses in the EU.

The ATAD addresses a coordinated and coherent implementation of the OECD's recommendations on BEPS. Its adoption is the sign of a major political pressure to legislate at the EU level rapidly after the publication of the BEPS final reports. The ATAD sets measures to be adopted by all EU Member States in 5 specific fields:

- **Interest Limitation Rules**: as a general rule, the net borrowing costs are only deductible up to 30 percent of the taxpayer's EBITDA with the option to introduce a de minimis threshold of up to EUR 3 million. The net borrowing costs correspond to the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest, revenues and other economically equivalent taxable revenues that the taxpayer receives in accordance with national law. Where the taxpayer is a member of a consolidated group for financial accounting purposes, it may be entitled to apply a group ratio. Member States may exclude loans concluded before 17 June 2016 or used to fund certain public infrastructure projects and allow standalone taxpayers (*i.e.* a taxpayer that is not part of a consolidated group for financial accounting purposes and has no associated enterprise or permanent establishment) to fully deduct net borrowing costs. Certain carry-forward or carry-back rules are possible as regards the exceeding borrowing costs or unused interest capacity. Financial undertakings may further be excluded by the Member States.

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- **Exit Taxation Rules**: a transfer of assets by the taxpayer from the head office to a permanent establishment in another Member State or in a third country whereby the Member State of the head office no longer has the right to tax the transferred assets due to the transfer triggers as a rule capital gains taxation on such assets (i.e. taxation of the difference between the fair market value and the book value of the assets at the date of the transfer). The same treatment applies to (i) a transfer of assets from a permanent establishment to its head office or another permanent establishment in another Member State or in a third country, (ii) a transfer of the taxpayer's tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State or (iii) a transfer of the taxpayer's business carried on by a permanent establishment from a Member State to another Member State or to a third country. For EU and EEA transfers, the taxpayer may be entitled to defer the payment of the exit tax over 5 annual instalments. Certain temporary transfers not exceeding 12 months are excluded.

- **General Anti-Abuse Rule**: the General Anti-Abuse Rule ("**GAAR**") allows Member States to ignore artificial arrangements for calculating corporate tax liability. An artificial arrangement is defined very broadly as an arrangement or a series of arrangements which, having been put into place for the main purpose or as one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part. An arrangement or a series of arrangements are regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality. Where arrangements or a series of arrangements are ignored, the tax liability will be calculated in accordance with national law.

- **Controlled Foreign Company Rules**: the Controlled Foreign Company ("**CFC**") Rules allow Member States to include non-distributed income of a CFC of the taxpayer into the tax base of such taxpayer, provided the income of the CFC is derived (i) from certain income categories or (ii) from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage. The relevant income categories include interest, royalties, dividends, financial leasing, insurance, banking or other financial activities, as well as income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises, and add no or little economic value. A CFC is defined as an entity or a permanent establishment (i) in which the taxpayer by itself, or together with its associated enterprises, holds a direct or indirect participation of more than 50 percent of the voting rights, or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits and (ii) the actual corporate tax paid on its profits by the entity or permanent establishment is lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment. Losses of the CFC are not included in the tax base but may be carried forward, in accordance with national law, and taken into account in subsequent tax periods. Under certain circumstances, Member States may opt not to treat financial undertakings as CFCs. Finally, the undistributed income of the CFC is allocated in proportion to the taxpayer's interests in the CFC and the taxpayer is entitled to a tax credit at the time of the distribution of the CFC's income.

- **Hybrid Mismatches**: the ATAD implements rules to avoid mismatches between domestic legislations by hybrid instruments or entities, allowing for double non-taxation. In the event that a hybrid mismatch results in a double deduction (*i.e.* deduction from the tax base in the source and no inclusion in the tax base in the residence State), the deduction will be accorded only in the source State while the residence State will include the amount in the tax base. In the event that the residence State does not include the amount into the tax base, the source State will refuse the deduction. The anti-hybrid provision only applies to hybrid mismatches between EU Member States. However, a proposal should be released by October 2016 with respect to hybrid mismatches with third countries in order to be coherent with the OECD BEPS Report on that matter.

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The ATAD sets out minimum provisions and does not preclude Member States from adopting more severe domestic or bilateral provisions. It is noteworthy that the measures included in the ATAD follow the principles set out by the OECD BEPS Report as regards hybrid mismatches (Action 2), CFC Rules (Action 3), Limitation of Interest Deductions (Action 4) and the GAAR (Action 6) even surpassing them by adding exit taxation and using broader definitions. An initially envisaged "Switch-Over Rule" has meanwhile been abandoned since no agreement in this respect could be reached by the EU Member States. Nonetheless, the envisaged measures may impact Luxembourg tax laws as follows:

	Existing in current Luxembourg law	Anticipated changes	Implementation
Interest Limitation Rules	Partially included	▪ Financing companies: no impact since limitations only apply on "net" borrowing costs ▪ Financial institutions: excluded ▪ Holding companies: debt to equity ratio and requalification of excessive interest into non-deductible dividends already applies	31 December 2018 (extension available up to 2024 for Member State already implementing interest limitation rules)
Exit Taxation Rules	Included	Current unlimited tax deferral to be restricted to 5 years and EU/EEA Member States	31 December 2019
GAAR	Included	Current GAAR under the participation exemption to be extended	31 December 2018
CFC Rules	None	Limited impact for holding companies (since the participation exemption requires as a general rule a subject to tax condition)	31 December 2018
Hybrid Mismatch Rules	Included	Current hybrid mismatch rule under the participation exemption to be extended	31 December 2018

Amendment to the US/Luxembourg double tax treaty

The United States and Luxembourg have been negotiating the current double tax treaty ("**DTT**") for several months, targeting a mismatch in their domestic legislations as to the recognition of a US permanent establishment of a Luxembourg company. Under the current rules, certain US source income derived by Luxembourg companies is qualified from a Luxembourg perspective as being realised by a US permanent establishment – and hence exempt in Luxembourg in accordance with the DTT – while from a US tax perspective no taxable permanent establishment is recognised, thus leading to a double exemption.

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In line with Action 7 of the OECD BEPS Report, the US and Luxembourg agreed to amend the DTT through a Protocol in order to avoid the above-mentioned mismatch. The proposed amendment follows Article 1.8. of the 2016 US double tax treaty model and should read as follows:

Where an enterprise of a Contracting State derives income from the other Contracting State, and the first-mentioned Contracting State treats that income as attributable to a permanent establishment situated outside of that Contracting State, the benefits of this Convention shall not apply to that income if:

a) the profits that are treated as attributable to the permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and the state in which the permanent establishment is situated that is less than the lesser of (i) 15 percent or (ii) 60 percent of the general statutory rate of company tax applicable in the first-mentioned Contracting State; or
b) the permanent establishment is situated in a third state that does not have a comprehensive convention for the avoidance of double taxation in force with the Contracting State from which the benefits of this Convention are being claimed, unless the first-mentioned Contracting State includes the income treated as attributable to the permanent establishment in its tax base.

However, if a resident of a Contracting State is denied the benefits of this Convention pursuant to this paragraph, the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention with respect to a specific item of income if such competent authority determines that such grant of benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which the request has been made shall consult with the competent authority of the other Contracting State before either granting or denying a request made under this paragraph by a resident of that other Contracting State.

Accordingly, where a Luxembourg company derives income from the US and Luxembourg treats such income as attributable to a US permanent establishment, DTT benefits may be denied if the profits of the permanent establishment are subject to tax in the US at a rate of less than (i) 15% or (ii) 60% of the Luxembourg corporate income tax (*i.e.* currently 12.6%). In such case, the income may be taxed locally while strictly speaking Luxembourg would, under domestic tax law and absent an applicable treaty, apply the credit method to avoid double taxation.

The current bill of law foresees that the Protocol is applicable to amounts paid or credit as from the 3rd day following the publication of the law in the Luxembourg official Gazette, even though the Protocol is ratified by the US at a later date, in which case the Protocol will be applicable with retroactive effect.

OECD Guidance on Country-by-Country ("CbC") reporting

The recently published OECD Guidance on CbC reporting provides for some substantial clarifications on the application of CbC reporting by (i) highlighting in particular the application of the CbC reporting to investment funds and (ii) the introduction of a transitional measure for the voluntary filing of CbC reports ("**parent surrogate filing**"). In addition, some guidance was provided on the impact of exchange rate fluctuations on the agreed EUR 750 million filing threshold for MNE groups as well as the application of CbC reporting to partnerships.

With regard to the application of CbC reporting to investment funds the new guidance stresses again as laid out in the BEPS Action 13 Report that no general exemption for investment funds exists. Whether an investment fund or an affiliate has CbC reporting obligations must be determined on the basis of the definition of "multinational group" which is assessed on the basis of local accounting consolidation rules. As a result, in order to minimise CbC reporting obligations for investment funds and their subsidiaries, and as clarified in the CbC guidance, it is therefore important to assess to what extent foreign and Luxembourg accounting rules may allow investment entities (including affiliates thereof) not to consolidate with investee companies (*e.g.* through the application of a fair value approach).

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On the transitional measures, BEPS Action 13 recommends that CbC reporting will already be introduced by participating jurisdictions for MNEs' fiscal periods commencing on or from 1 January 2016. Due to legislative procedures however it is likely that various participating jurisdictions will not be able to implement these measures in time which would as consequence make multinationals resident in these jurisdictions subject to local filing requirements in various jurisdictions absent any transitional measures. The guidance therefore allows participating jurisdictions to accommodate voluntary filing on the basis of a report in line with the requirements set forth in the BEPS Action 13 report for Ultimate Parent Entities resident in their jurisdictions, the so-called parent surrogate filing. This allows for minimizing local filing obligations for multinationals under the CbC reporting standard. Japan, Switzerland and the United States have expressed their intention to introduce such voluntary parent surrogate filing rules.

In addition, during the OECD's Committee on Fiscal Affairs meeting in Kyoto on 30 June 2016, five countries (Argentina, Curacao, Georgia, Korea, and Uruguay) signed the Multilateral Competent Authority agreement for the automatic exchange of Country-by-Country reports under the BEPS Project, bringing the total number of signatories to 44 countries.

Conclusion

The ATAD and the Protocol are in line with the current developments of the OECD's BEPS project and their implementation should be closely monitored since they may impact taxpayers with a presence in Luxembourg in different ways. Hence, we recommend adopting a prudent approach and observing the following steps:

1) Review existing structures to assess potential impacts of the ATAD, the Protocol and more generally the various BEPS Actions
2) Analyse potential alternatives and practical consequences
3) Implement the appropriate adjustments and determination of the necessary internal procedures (*e.g.* tax reporting)

Would you need any further information, please do not hesitate to contact our Tax team: Eric Fort, Alain Goebel, Thierry Lesage and Jan Neugebauer or your usual contact within the team. They are at your disposal to further guide you towards the right solution.

This publication is intended to provide information on recent legal developments and does not cover every aspect of the topics with which it deals. It was not designed to provide legal or other advice and it does not substitute for the consultation with legal counsel before any actual undertakings.

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