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CHANCE

THE MULTILATERAL INSTRUMENT ENTERS INTO FORCE

On 14 February 2019, the Luxembourg Parliament adopted bill of law 7333 ratifying the Multilateral Convention ("**MLI**") which implements Tax Treaty Related Measures preventing Base Erosion and Profit Shifting ("**BEPS**") that might impact all 81 double tax treaties ("**DTT**") concluded by Luxembourg.

Key issues

- BEPS implementation affects 81 Luxembourg double tax treaties
- MLI entry into force on 1 August 2019
- Luxembourg's position through options and reservations

PURPOSE OF THE MLI

The purpose of the MLI is to fight BEPS and to ensure that the income is taxed in the jurisdiction where economic activity generates profits and where value is created. The MLI will allow the different jurisdictions to meet the requirements foreseen by the BEPS action plan by establishing one single legal framework that can apply to all existing DTTs.

IMPACT ON THE LUXEMBOURG DTT

The MLI has already entered into force in 15 countries, including Australia, Austria, Finland, France, Guernsey, the Isle of Man, Israel, Japan, Jersey, Lithuania, New Zealand, Poland, Slovak Republic, the United Kingdom, Serbia, Slovenia and Sweden. By the time the MLI enters into force in Luxembourg, this list will be extended by six other countries (i.e. Finland, Guernsey, Ireland, Malta, Monaco and Serbia).

In respect of Luxembourg, the MLI will enter into force on the first day of the month following a three-calendar-month period after the deposit date of the ratification instrument with the OECD, e.g. since Luxembourg deposited its ratification instrument on 9 April 2019, the MLI will enter into force on 1 August 2019.

Although Luxembourg has notified all 81 of its DTT to the OECD as treaties falling within the scope of the MLI, the Luxembourg tax treaty network will not immediately be entirely affected, since only Covered Tax Agreements ("**CTAs**"), i.e. treaties where both jurisdictions have been notified to the depositary as listed agreements under the MLI, will be impacted. Moreover, provisions and amendments of a specific tax treaty will only enter into force where both parties to a treaty have deposited their instrument of ratification or approval of the MLI. Therefore, when the MLI enters into force in Luxembourg, DDT will be impacted with all the above listed countries except for Australia and New Zealand.

Nevertheless, even when the MLI has entered into force, it will take some more time for its provisions (*inter alia* the principal purpose test) to have effect as regards the different types of taxes.

For withholding taxes, the MLI will become effective on the first day of the year following the latest date of entry into force of the MLI. For instance, since

Luxembourg deposited its instrument of ratification in April 2019, the MLI provisions will then affect withholding taxes as of 1 January 2020.

Provisions as regards all other taxes will apply in the first taxable period, after[BM1] a six-months period following the entry into force. Taxpayers with taxable periods corresponding to a calendar year, will thus need to apply the provisions as of 1 January 2021.

FUNCTIONING OF THE MLI

The flexibility of the MLI allows its signatories to express reservations, i.e. to opt out of certain provisions, either entirely or partly, provided they do not pertain a BEPS minimum standard (e.g. the prevention of treaty abuse, the dispute resolution and the preamble clause). Optional provisions can also be chosen by signatories, but these would only apply where both parties have chosen identical options (Matching Principle).

Finally, the MLI requires each signatory to deposit its very own MLI position with the OECD and to set out any reservations and optional provisions therein.

LUXEMBOURG'S POSITION

In addition to the mandatory minimum standards which must be complied with by each signatory, Luxembourg has opted into, and made reservations on, several provisions as follows.

Transparent entities – Article 3 MLI

The objective of this provision is to introduce the new article 1(2) of the OECD Model Tax Convention which addresses income earned through transparent entities (the approach is in line with the OECD's Partnership Report)[1].

Luxembourg opted into Article 3 by choosing to apply the **transparent entities provision** which denies treaty benefits on payments via reverse hybrid instruments. In addition, a reservation has been made on Article 3(2), leading to a non-application of this part of the provision, which denies relief for double-taxation where the other State's tax is levied solely on the basis of residence.

For purposes of tax treaty benefits,the provision disregards a transparent entity and grants such benefits directly to the entity's holder (partner) if the latter is taxed in its home country. Consequently, income derived by a partner, resident in one State, through a transparent entity (e.g. partnership) established in the other State, will be considered as income of that partner, if that income is treated as such for tax purposes in its residency State.

Elimination of double taxation – Article 5 MLI

Luxembourg opted for option A of Article 5 which provides that the residency State, in order to eliminate double-taxation, should apply the credit method instead of the exemption method where income is, pursuant to the CTA, tax-exempt or treated at a lower tax rate in the source State. Therefore, Luxembourg would not grant an exemption (e.g. as foreseen by a double-tax treaty) but rather a tax credit, where the other State applies the tax treaty to exempt such income from taxation.

Since this provision is not subject to the "Matching Principle" it will still apply to Luxembourg residents even when the other State has not chosen the same option, to the extent that it has not made a reservation not to apply the provision. However, as this could lead to asymmetrical application disrupting the balance

[1] 1999 OECD Report on the Application of the OECD Model Tax Convention to Partnerships.

of certain treaties, Luxembourg has chosen, with respect to several identified CTAs, not to permit the other Contracting Jurisdiction to apply option C; option C being the credit method for the elimination of double-taxation.

Ensuring the minimum standard – Article 6 MLI

Luxembourg has decided to include the preamble wording in all of its 81 CTAs setting out a minimum standard clarifying the intention of the parties to ensure that CTAs are being interpreted in a coherent manner. Where Luxembourg's treaty partners notify the same wording, any previous wording will be replaced. In all other cases, the preamble wording will be added to the existing one.

Prevention of treaty abuse – Article 7 MLI

All treaties concluded by Luxembourg will contain the **principle purpose test** ("**PPT**") pursuant to which tax treaty benefits will be denied, where one of the main purposes of an arrangement or a transaction is to obtain the treaty benefits.

However, Luxembourg opted to include a competent authority relief provision, under which a person who has been denied the benefit of the treaty shall nevertheless benefit from it if the competent authority determines that such benefits would have been granted to that person in the absence of the transaction or arrangement.

It is noteworthy that Luxembourg did not opt for the simplified limitation on benefits clause (the "**simplified LOB**") which denies treaty benefits where the claimant is not a qualified person under a CTA (such as an individual or a company whose shares are traded on a recognised stock exchange).

It is expected that Luxembourg's choice will have substantial impact on treaty eligibility in new and existing holding and financing structures, increasing requirements on substance and functionality.

Artificial avoidance of PE Status – Articles 13 MLI

Finally, Luxembourg opted into a provision aiming at preventing **artificial avoidance of permanent establishment ("PE") status** through specific activity exemptions. Luxembourg chose option B, according to which activities currently listed in a CTA (such as the use of facilities for the purpose of storage or delivery of goods referring to warehouses) do not need to be of a preparatory or auxiliary character to not constitute a PE. Conversely, any other activity or the combination of all activities needs to be of preparatory or auxiliary character in order to not constitute a PE. In practice, even though this provision should only be relevant where both parties have chosen the same option, structures relying on a specific activity exemption should be reviewed.

CONCLUSION

As the MLI has now been ratified by parliament and proposed to the OECD, it will enter into force. When it comes to applying the MLI between Luxembourg and one of its 81 treaty partners, all the reservations and their impact on the relevant CTAs must be analysed on a case-by-case basis. Given the straightforward timeframe, it is crucial to understand, in advance, the potential impact of the new provisions on current structures in order to mitigate risks by the time they become applicable.

By choosing the PPT to apply to its DTT network, Luxembourg has clearly taken the road to promote onshore set-ups demanding an adequate level of substance and a valid business rationale for structures established in the Grand-Duchy. Securing treaty access, concerned taxpayers must ensure that they demonstrate appropriate substance in order to meet the PPT requirements and benefit from the DTT.

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