Luxembourg adopted the Multilateral Instrument

<u>Background</u>

On June 2017, Luxembourg signed the multilateral instrument (hereafter, "**MLI**") to implement tax treaty-related measures to prevent base erosion and profit shifting (hereafter, "**BEPS**").

On February 2019, the Luxembourg parliament adopted the law ratifying the MLI. The law dated March 7, 2019 approving the MLI was published in the Luxembourg *Mémorial* on March 14, 2019.

The list of tax treaties in force that Luxembourg designated as Covered Tax Agreements (hereafter, "**CTAs**") contains all of its 81 tax treaties that are currently in effect. However, all these treaties will not be impacted by the MLI. An existing CTA will only be modified by the MLI if the other Contracting Jurisdiction has also designated the treaty with Luxembourg as a CTA.

Except for certain mandatory minimum standards, the MLI provides flexibility to countries through opt-in and opt-out mechanisms, as well as the possibility to apply alternative provisions.

The main options and reservations made by Luxembourg are summarised below. In a nutshell, apart from the minimum standards, Luxembourg accepted only a few optional rules.

<u>Minimum standards</u>

<u>Purpose of a CTA (article 6)</u>

Article 6 modifies the preamble language of a CTA to express that tax treaties are intended to eliminate double taxation without creating the opportunities for non-taxation or reduced taxation through tax evasion or avoidance.

All the tax treaties signed by Luxembourg (except the treaty with Senegal which contains already an equivalent provision) will be modified to include the above-mentioned preamble language.

<u>Prevention of treaty abuse (article 7)</u>

In accordance with article 7, countries must include one of the following provisions to prevent treaty abuse: (i) a principal purpose test (hereafter, "**PPT**") or; (ii) a detailed limitation of benefits provision supplemented by specific rules targeting conduit financing arrangements; or (iii) a combination of PPT and limitation of benefits provision.

Luxembourg opted to apply the PPT test. 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).

In addition, Luxembourg has elected to include the optional competent authority relief provision when treaty benefits are denied under the PPT test. According to that clause, the competent authorities involved must consult with each other before rejecting the relief request.

Mutual agreement procedures (article 16)

Article 16 requires countries to include in their tax treaties provisions with respect to mutual agreement procedures of article 25(1) through (3) of the OECD Model Tax Convention.

All the tax treaties concluded by Luxembourg include already mutual agreement procedures in line with the minimum standard. In addition, all the tax treaties signed by Luxembourg (except with Belgium, Canada, Italy and Portugal) are in line with the three-year minimum standard (taxpayer deadline for claims).

Options

Transparent entities (Article 3)

Luxembourg opted to apply Article 3 (1) that addresses the situation of hybrid mismatches as a result of entities that one or both contracting states treat as wholly or partly transparent for tax purposes. It provides that income derived by or through an entity that is treated as wholly or partly transparent under the tax law of either contracting state shall only be considered income of a resident to the extent that the income is treated, for purposes of taxation by that contracting state, as the income of a resident of that contracting state.

This option may be very beneficial – when there is a matched agreement with another contracting jurisdiction – as it confirms that the tax treaties should “look through” transparent entities and give treaty protection to their partners. This approach would be accepted provided that the final recipient is subject to tax on the income in its home state.

Corresponding adjustments (article 17)

Luxembourg has chosen to apply article 17 which requires countries to make compensatory or corresponding adjustments if there is double taxation arising out of transfer pricing adjustments.

Application of methods for elimination of double taxation (article 5)

Article 5 includes 3 alternative approaches to resolve problems that may be related to the use of the exemption method in the tax treaties.

Luxembourg opted to apply Option A under which no exemption will be granted with respect to income or capital that, pursuant to a CTA, is exempted or taxed at a reduced rate in the other contracting state. In the case of application of a reduced rate, Luxembourg will grant a tax credit for the foreign tax on the income or capital.

Artificial avoidance of permanent establishment status – Specific activity exemption (article 13)

To prevent artificial avoidance of permanent establishment status, Luxembourg has chosen option B for the specific activity exemption. Under this option, the list of activities specifically excluded from the definition of a permanent establishment in the CTA will also not create a permanent establishment as a result of the MLI, irrespective of whether that activity is of a *preparatory or auxiliary* character.

Mandatory binding arbitration (articles 18-26)

Luxembourg has decided to implement the arbitration procedure whereby a taxpayer may request a mandatory binding arbitration if the competent authorities were not able to reach a mutual agreement within two years.

Reservations

Dual resident entities (Article 4)

Article 4 modifies the rules for determining the treaty residence of a person – other than an individual – that is a resident of more than one Contracting Jurisdiction. According to this provision, treaty residence of a dual resident entity will be determined by a mutual agreement procedure between Contracting Jurisdictions.

The reservation against this provision implies that the current tie-breaker rules of Luxembourg tax treaties, which typically consider the jurisdiction where the place of effective management is situated as the residence country, would continue to apply.

Dividend transfer transactions (Article 8)

Under article 8, the withholding tax exemption or the application of a reduced withholding tax rate is subject to certain ownership requirements, which need to be met throughout a time period of 365 days.

The full reservation against this provision made by Luxembourg means that the MLI will have no impact on the dividend withholding tax provisions contained in Luxembourg tax treaties.

Capital gains from alienation of shares or interests in real estate-rich companies (Article 9)

Luxembourg has made a reservation against article 9 which provides with an anti-abuse rule with respect to capital gains realised from the sale of shares or interest in real estate-rich companies. It introduces a testing period referring to a relevant value threshold at any time during the 365 days preceding the sale. In addition, it expands the rule to apply to shares or comparable interests such as interests in a partnership or trust.

Anti-abuse rule for permanent establishments situated in third jurisdictions (article 10)

In accordance with article 10 treaty benefits will be denied if an item of income derived by a treaty resident and attributable to a permanent establishment in a third jurisdiction, is exempt from tax in the residence state and the tax in the permanent establishment jurisdiction is less than 60% of the tax that would be imposed in the residence state if the permanent establishment were located there. Luxembourg reserved its right not to apply this provision.

Application of tax agreements to restrict a party's right to tax its own residents (article 11)

Luxembourg reserved its right not to apply article 11 (so-called "saving clause") which preserves the right of a Contracting Jurisdiction to tax its own residents notwithstanding the provisions of a tax treaty.

Artificial avoidance of permanent establishments through commissionaire arrangements and similar strategies (article 12)

Luxembourg decided not to opt for the anti-abuse rule of article 12 that addresses the artificial avoidance of permanent establishment status through *commissionnaire* arrangements and similar strategies.

Splitting-up of contracts (article 14)

Luxembourg did not elect the option with respect to article 14, which is designed to prevent companies from artificially avoiding permanent establishment status by splitting up the duration of contracts into several shorter periods.

Definition of a person closely related to an enterprise (article 15)

Given that Luxembourg has not opted for any article that includes the definition of "person closely related to an enterprise", it has made full reservation on article 15.

Timing

For withholding taxes, the MLI will apply as from January 1, 2020 to the tax treaties concluded by Luxembourg with other jurisdictions that have completed the MLI ratification process prior to October 1, 2019.

For all other taxes, the MLI will apply to taxable periods beginning on or after the expiration of a period of six months from the latest of the dates on which the MLI enters into force for the two parties to a CTA.

For further information, do not hesitate to contact one of our team members, who will be glad to assist you at any time:

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