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Qualification of taxable entities and treaty protection

Patrick Mischo – Allen & Overy
Paul Berna – Allen & Overy
Frank van Kuijk – Loyens & Loeff
Introduction

Part 1: Domestic rules how local and foreign entities are qualified for Luxembourg tax purposes

Part 2: Case studies to illustrate how qualification/attribution conflicts are handled in Luxembourg
Part 1
Domestic Rules
Domestic entities

Domestic nature of an entity

- Registered office / central administration

- No domestic rules to solve dual residency issues

- But: residence as determined under tie-breaker rules of a tax treaty seem to be binding for Luxembourg tax purposes (i.e. not only for the purposes of the DTC)
  - Administrative Court 6 March 2011 (n°12521C) / Circular n°3-2 LIR
  - Doc. parl. n°4855/03 (law of 21 December 2001)

- Not in line with dominant position of international tax writers
  - K. Vogel, J. Schaffner and A. Steichen
Domestic entities (contd.)

Relevance of corporate law status

- Opaque entities: article 159 LIR
- Transparent entities: article 175 LIR / §11 StanpG

Corporate form decisive?

- A. Sulkowski (1995 IFA report): No, a civil company can be opaque if it has its own board of management
- Reporters: Yes. Case law makes no distinction + no indication to the contrary in any parlamentary works
Domestic entities (contd.)

Impact of tax exemptions

- Objective exemptions and special deduction regimes:
  - Remain opaque
  - Are still treated as fully taxable companies
  - Should in principle have access to tax treaties

- Subjective/full exemptions:
  - Remain opaque
  - Are not fully taxable entities
  - Virtual double taxation sufficient for treaty access
  - But, tax administration avoids unilateral interpretation of tax treaties (cf. SICAVs)
Foreign entities

How to classify foreign entities

- Resemblance test, unless classification is foreseen in Luxembourg tax laws (175 LIR and 11bis TAL)

- Explicit classification pursuant to article 175 LIR and 11bis TAL, if:
  - Legal form as mentioned in annex to PSD;
  - Tax resident in an EU Member State and not considered tax resident outside EU under a DTC; and
  - Subject to corporate taxation levied by EU Member State.
Foreign entities (contd.)

Classification of Dutch Open CV with POEM outside Luxembourg

- Classification as opaque pursuant to Luxembourg tax laws:
  - Legal form mentioned in Annex to PSD ✓
  - Tax resident in an EU Member State ✗
  - Subject to corporate taxation levied by Member State ✗

- Classification pursuant to Luxembourg tax laws not possible.

- Conclusion: classification of the Dutch Open CV pursuant to resemblance test.
Foreign entities (contd.)

What is the resemblance test and why can it be applied?

- Compare features of foreign entities with Luxembourg entities.
- Its existence does not follow from the Luxembourg tax laws, but follows from parliamentary history (PjL 571/4 & PjL 5292/00).
- Confirmed for first time by Luxembourg Administrative Court 10 January 2006, #20307C
How to apply the corporate resemblance test

- Features of foreign entity more comparable to features of Luxembourg opaque entities > foreign entity is opaque.

- Features of foreign entity more comparable to features of Luxembourg transparent entities > foreign entity is transparent.

- Which features must be taken into consideration? Luxembourg law and parliamentary history are not clear.
Relevance of legal personality

Practitioners and tax administration seek guidance in German case law and doctrine and generally consider the following features:

- Centralized management vs. decentralized management;
- Limited liability vs. unlimited liability;
- Free transferability vs. limitations on transferability;
- Unlimited duration vs. limited duration;
- Legal personality vs. absence of legal personality (?)

Not one criteria decisive, overall similarity counts, but the first three seem to carry more weight (see Luxembourg Administrative Court 10 January 2006, #20307C and PJL 571).
Foreign entities (contd.)

Relevance legal personality

- Position in doctrine (prior to introduction of SLP) is taken that legal personality is irrelevant for being opaque as all Luxembourg partnerships do have legal personality by law.

- This position have been weakened as partnerships can now be set up without legal personality (AIFMD Law 12 July 2013).

- The AIFMD Law introducing the special limited partnership thus has effect on the application of the corporate resemblance test.
Foreign entities (contd.)

Drawbacks of the resemblance test

• Difficult to get clarity on legal features of a foreign entity (unknown or concepts have a different meaning).

• There is not a single legal feature that only appears in either tax opaque or tax transparent entities:
  – Centralized management in an SCS;
  – Unlimited liability for the GP of an SCA;
  – No free transferability for an SARL; and
  – Legal personality for an SLP.
Foreign entities (contd.)

Relevance foreign tax treatment for classification

- Dominant approach in doctrine: foreign tax treatment not relevant

- Implicitly confirmed in PjL 5492/00, which classified EU entities subject to tax as opaque.

- Explicitly confirmed in Luxembourg Administrative Court 10 January 2006, #20307C, classification French SCI: French tax treatment was considered as irrelevant.

- Conclusion: corporate resemblance test
Part 2
Case Studies
Purpose of case studies

• How does Luxembourg handle qualification/attribution conflicts?

• More particularly: how has Luxembourg legislation/practice evolved since the OECD Partnership Report?

• Reality: no particular legislation, no circulars, no relevant case law
Would/should we apply the Partnership Report?

- No reservations by Luxembourg

- Generally: tax practitioners, tax administration and tax courts follow OECD commentaries if tax treaty is in line with OECD MC

- Static vs dynamic approach of commentaries

- Commentaries from Partnership Report mere clarifications?

- Administrative practice? Division of international affairs: no practical experience, but they would consider the Partnership Report
Main principles of the Partnership Report

Principle 1

The source State has to take into consideration in whose hands the income is taxed in the residence state.
Main principles of the Partnership Report

Principle 2

For the purposes of the avoidance of double taxation under the tax treaty, the residence state has to follow the income qualification made by the source state.
Case 1

If Luxembourg is State S

- Luxembourg’s taxation rights would be restricted by its tax treaty with state P as the entity is a tax resident of state P (income is not flowed through to the partners from the perspective of state P).
- Luxembourg’s taxation rights would also be restricted under its tax treaty with state R as, from state R’s perspective, the income is flowed through to the partners, given that the entity is tax transparent from state R’s perspective.
Case 2

If Luxembourg is State S

- Luxembourg’s taxation rights would not be restricted by its treaty with state P as the entity is not a tax resident in state P (not liable to taxation in state P)
- Luxembourg’s taxation rights would also not be restricted under its treaty with state R as from state R’s perspective, the income has not flowed through to the partners (the entity is tax opaque from state R’s perspective).
Case 3

**Luxembourg as state P**
- This is a pure domestic situation: the entity is a tax resident of Luxembourg as it is subject to taxation in Luxembourg.
- Luxembourg not required to take into account income allocation made by State P, i.e. Luxembourg would not be restricted to tax the income/royalty income.
Case 3 (contd.)

**Luxembourg as state R**
- Situation of state R not addressed in the Partnership Report / commentaries
- Luxembourg would allocate the gross interest/royalty income to the partners and tax accordingly, unless if we follow the qualification of the entity made by state S
- Can Luxembourg ignore existence of tax resident in state P? Reporters think this would be contrary to the tax treaty
Case 3 (contd.)

Luxembourg as state R (contd.)

- Luxembourg must consider that state P has taxed the income in accordance with the treaty and grant the appropriate tax relief

- But what is the appropriate relief?
  - Interest/royalty income taxed in accordance with article 10/12? If so, the income would, as applicable for the relevant income category, have to be exempt or a tax credit would have to be given for the withholding tax and corporate taxes levied on the interest/royalty income by state S
  - But: but article 10/11 only concern interest/royalty payments arising in one contracting state and paid to the other contracting state. A domestic situation as in this case is not covered by article 10/11
  - Taxed as Other Income (article 21) or business profits attributable to a PE (article 7)? Luxembourg would under most treaties have to exempt the income.
Revisiting case 1

If Luxembourg is State R

- Luxembourg cannot ignore existence of tax resident in state P
- Luxembourg would have to exempt interest/royalty income due to tax treaty with state P (PE in state P or other income realised by entity)?
Case 4 - Dividends

Facts
State S taxes the generation and distribution of the income.

Credit for tax on generation
- Luxembourg and source state tax the generation of the income;
- Luxembourg grants credit for state S tax (par. 139 Report).

Credit for tax on distribution
- Luxembourg does not recognize the distribution;
- No Luxembourg tax imposed on the distribution, so no possibility to credit any tax on the distribution.
Case 5 - Interests
Luxembourg as state A

- Luxembourg imposes withholding tax under domestic law on the payment of the following types of interest:
  - Profit contingent interest (146,2 LIR) and;
  - Interests on securities contingent on the profit distributions of the debtor (146,3 LIR) provided the interest is of a domestic nature and therefore the:
    - debtor should be individual or collective entity under private law (collectivité de droit privé)
    - individual must be Luxembourg domiciled and entity must have its statutory seat or central administration in Luxembourg?

- Who is the debtor? entity that is considered the debtor from a legal perspective.
- What is a collective entity under private law? Certainly a tax opaque entity but possibly also a transparent entity.
Luxembourg as state A (contd.)

- Luxembourg is State A, withholding tax under domestic law? If so, application of article 11 DTC?

  - Possible solution if P has legal personality:
    - Partners are not debtors, thus no withholding tax

  - Possible solution if P has no legal personality:
    - Partners are debtors and individuals domiciled in Luxembourg, thus withholding tax. Withholding to be reduced under 11 DTC as it arises in Luxembourg.
Luxembourg as state B

- Luxembourg is State B, withholding tax under domestic law? If so, application of article 11 DTC?

  - Possible solution if P has legal personality:
    - P is the debtor and a (arguably) a collective entity under private law which has its statutory seat/central administration in Luxembourg, thus withholding tax. No application of article 11(2) DTC as the interest does not arise in Luxembourg instead 7/21 DTC applies, meaning no taxation rights for Luxembourg.

  - Possible solution if P has no legal personality:
    - Partners are debtors but no individuals domiciled in Luxembourg, thus no withholding tax.
Case 5 – Interests (contd.)

**Luxembourg as state C**

- Luxembourg is State B, withholding tax under domestic law? If so, application of article 11 DTC?

  - Possible solution if P has legal personality:
    - P is the debtor and a (arguably) a collective entity under private law which has its statutory seat/central administration in Luxembourg, thus withholding tax. No application of article 11(2) DTC as the interest does not arise in Luxembourg instead 7/21 DTC applies, meaning no taxation rights for Luxembourg.

  - Possible solution if P has no legal personality:
    - Partners are debtors but no individuals domiciled in Luxembourg, thus no withholding tax.
Luxembourg as state C

- Credits are only granted if interest taxed in accordance with the treaty.
- Interest is taxed in accordance with treaty if it arises in a contracting state.
- Interest arises in a contracting states if the payer is a resident there.
- Luxembourg likely takes a legal approach and considers thus as payer the payer from a legal perspective.
Case 5 – Interests (contd.)

Luxembourg as state C

Proposed solution if P has legal personality:

- Withholding tax State B: as the payer is not resident there: no credit
- Withholding tax State A: as the partners are not the payers: no credit

Proposed solution if P has no legal personality:

- Withholding tax State B: as P is not the payer: no credit
- Withholding tax State A: as the partners are the payers and are residents: credit
Questions?

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