

2014 IFA Report

*Qualification of taxable entities  
and treaty protection*

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# 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 entites: 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 parliamentary 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

# Foreign entities (contd.)

## 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.

# Foreign entities (contd.)

## 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 P JL 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



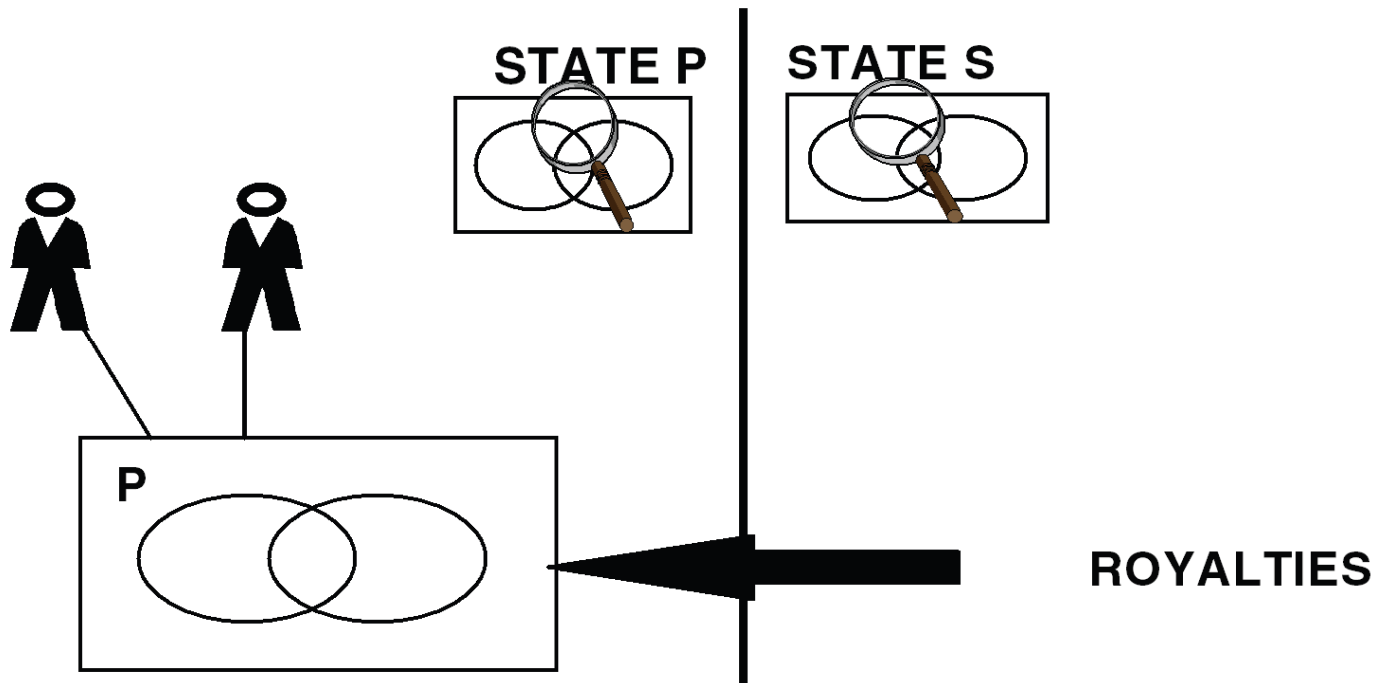
# Would/should we apply the Partnership Report?

- 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

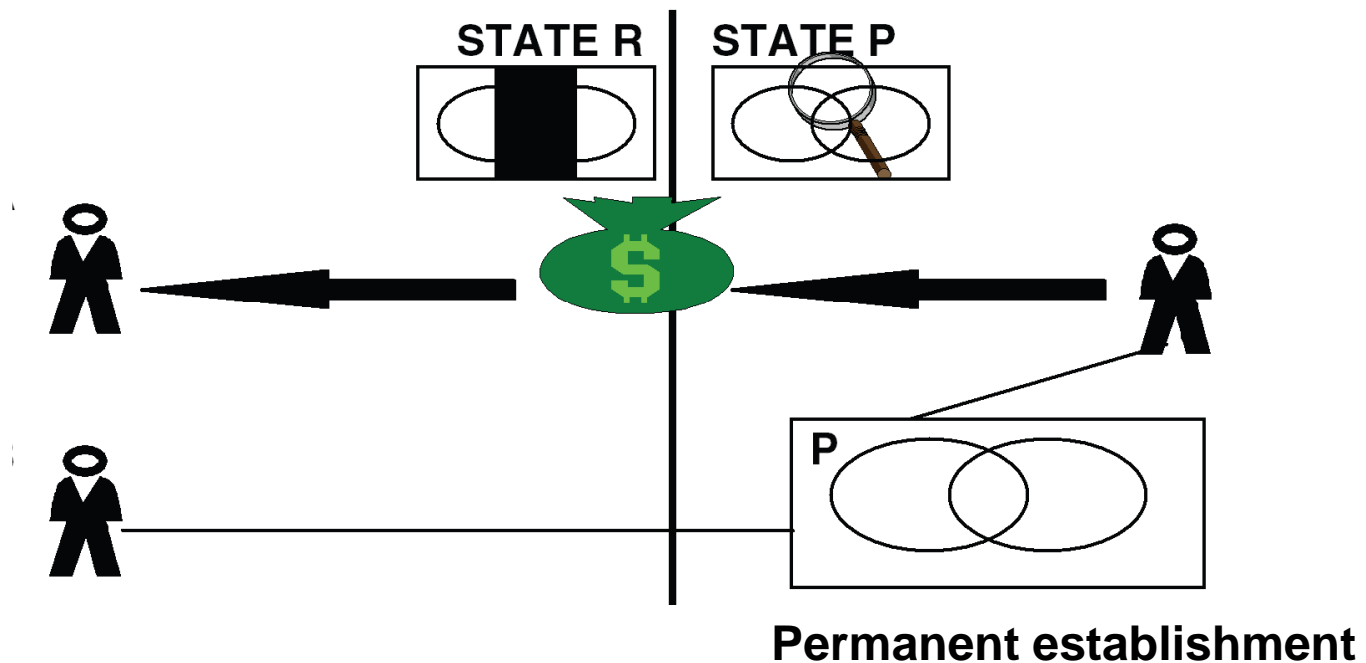
The source State has to take into consideration in whose hands the income is taxed in the residence state



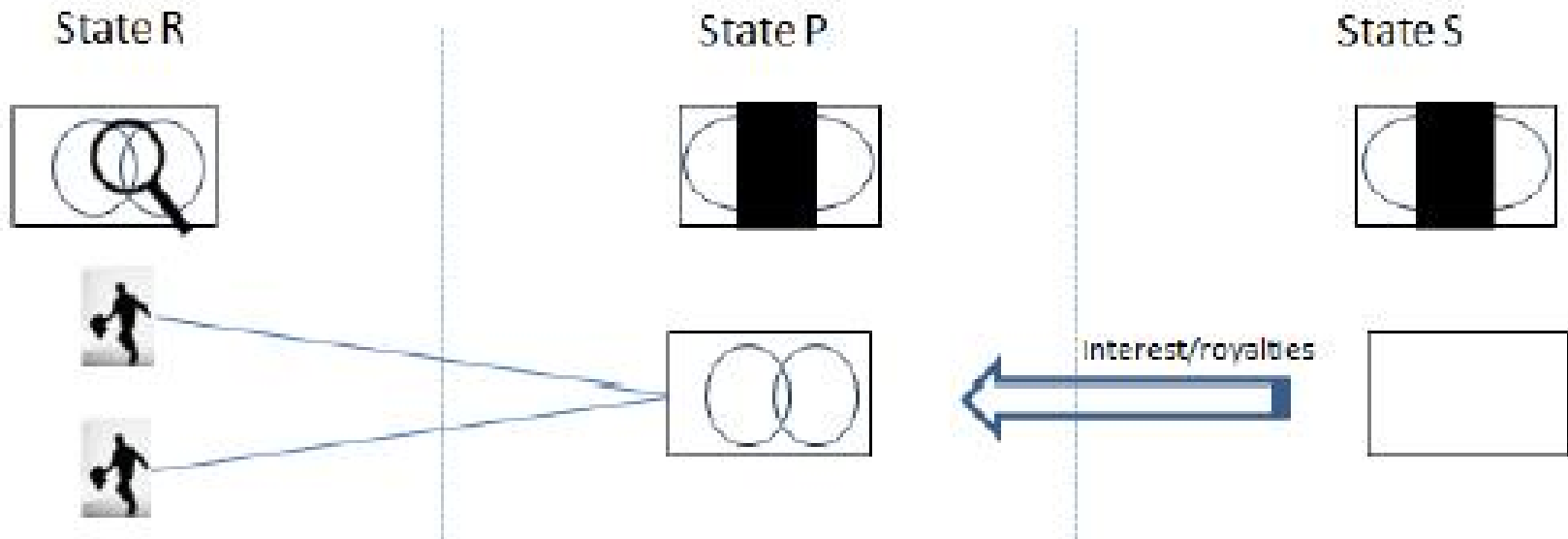
# Main principles of the Partnership Report

## 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.



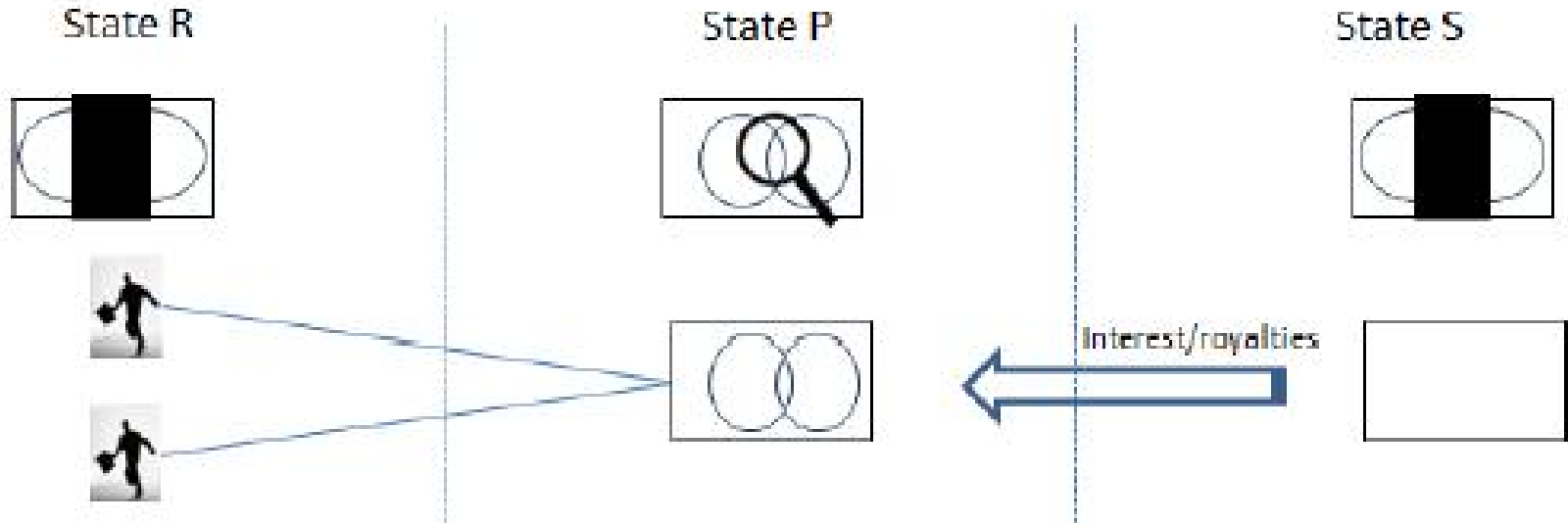
# Case 1



## 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

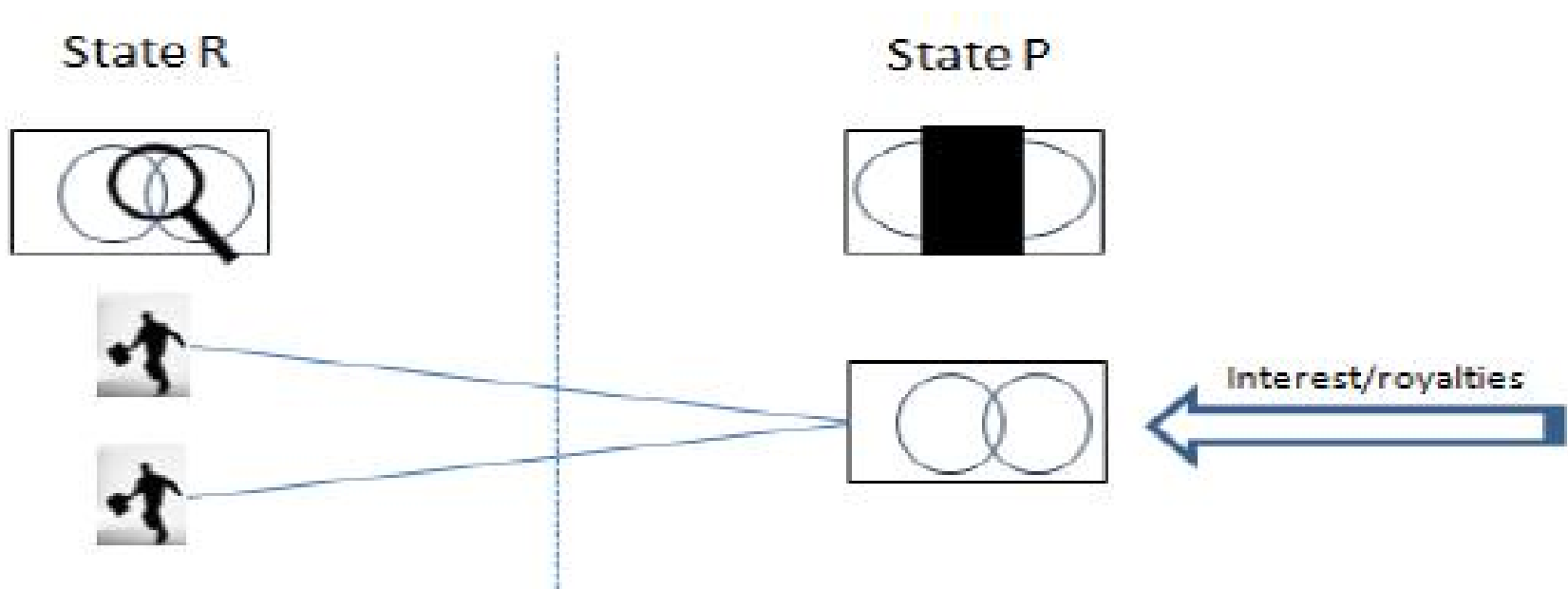
## Case 2



### 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

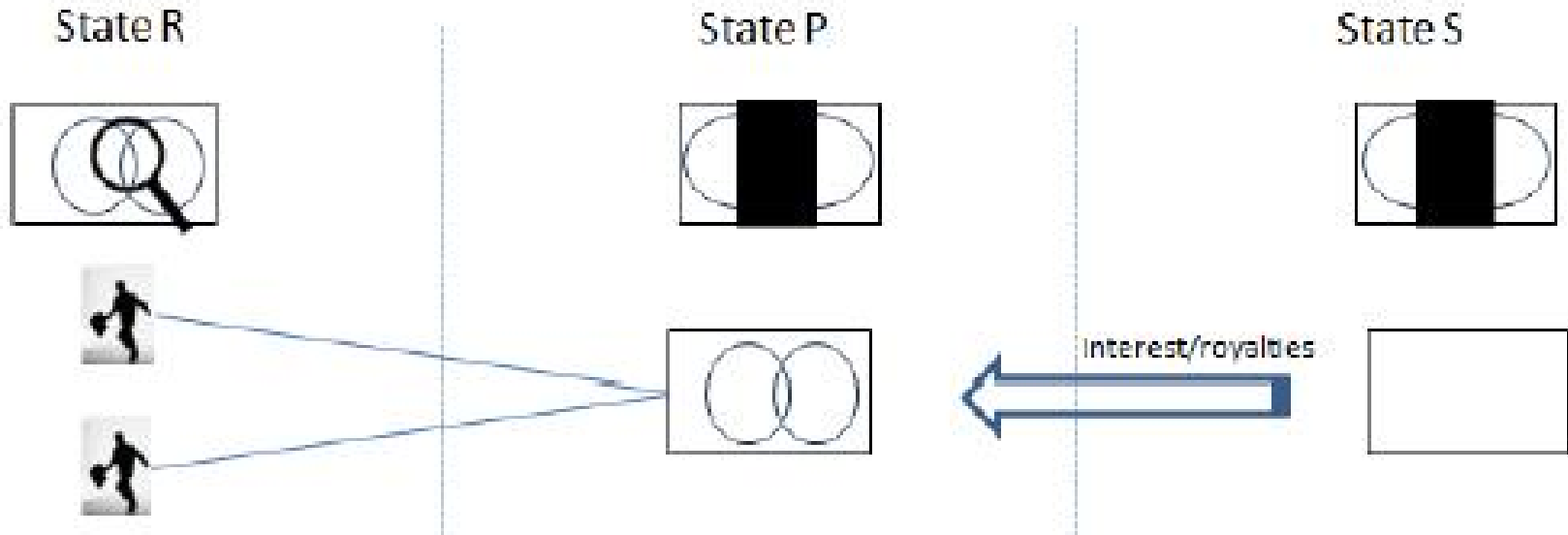
## Case 3 (contd.)

### 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.



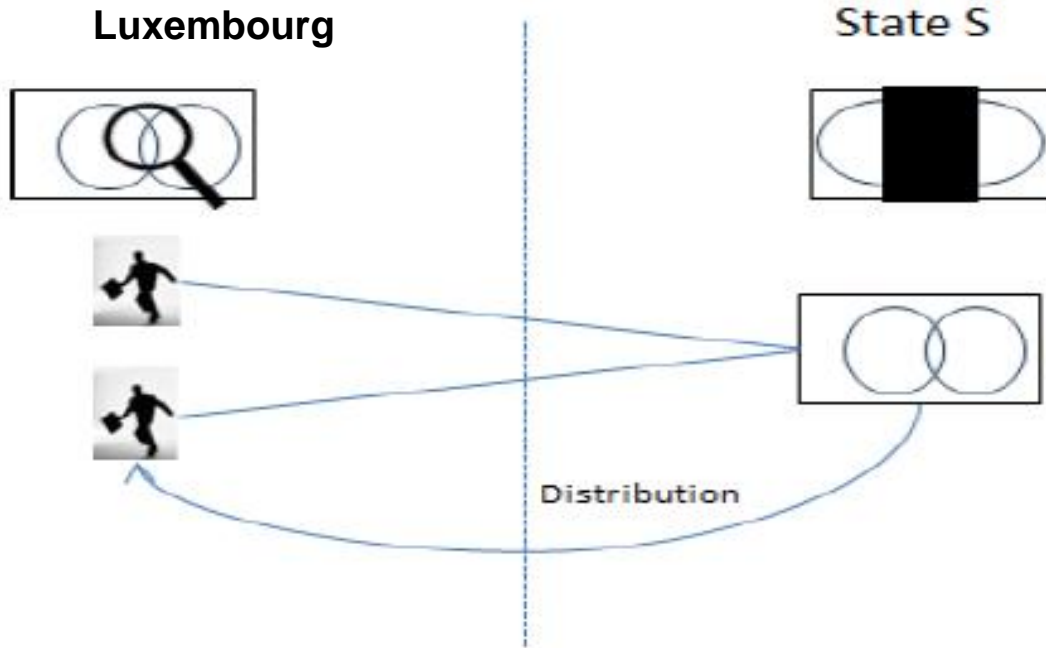
# Revisiting case 1



## 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.

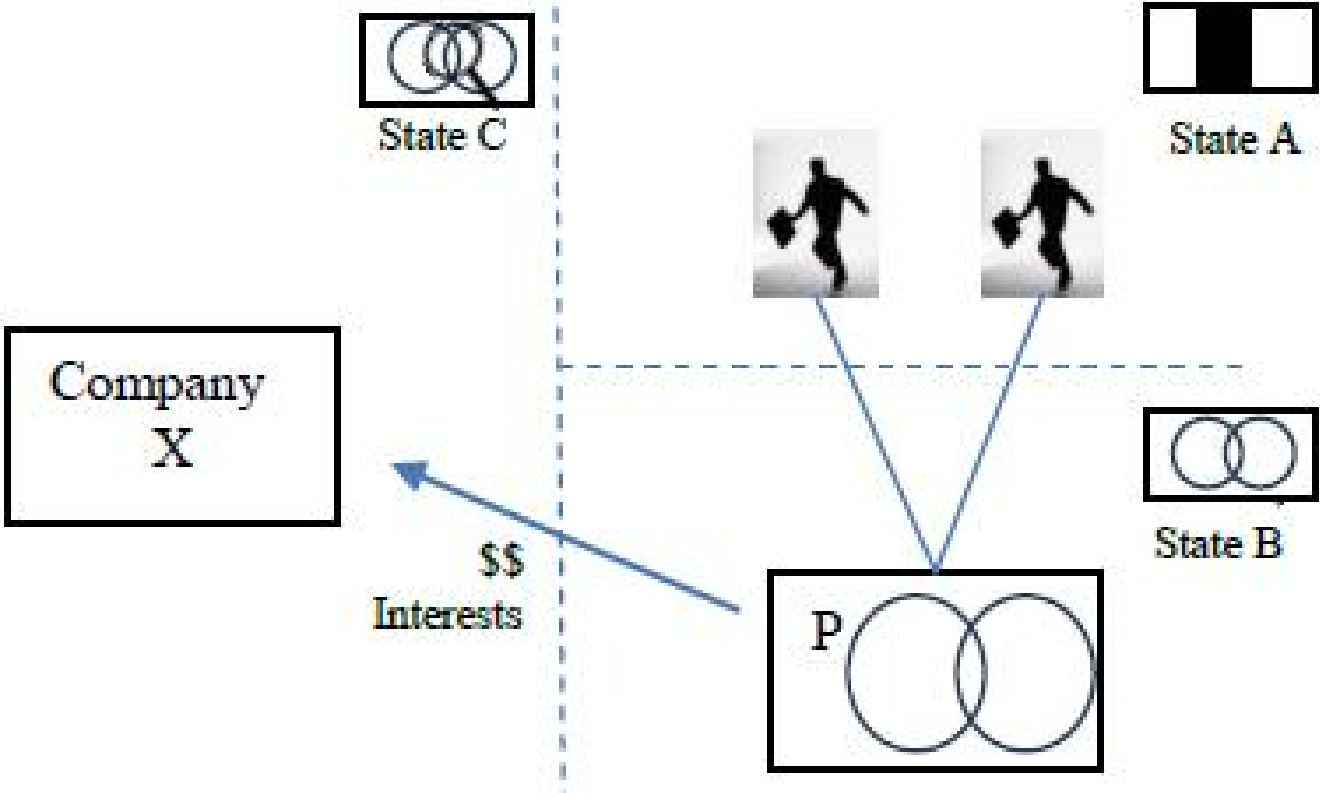
## Credit for tax on generation

- 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



# Case 5 – Interests (contd.)

## 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.

## Case 5 – Interests (contd.)

### 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.

# Case 5 – Interests (contd.)

## 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.

## Case 5 – Interests (contd.)

### 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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