Luxembourg implements BEPS actions into tax treaties by signing the multilateral instrument

On 7 June 2017 during an OECD ceremony, Luxembourg signed the multilateral instrument (MLI) to implement tax treaty-related measures to prevent base erosion and profit shifting (BEPS).

The MLI was signed, in total, by 68 jurisdictions. Eight jurisdictions expressed their intention to become signatories of the MLI and more are expected to follow by the end of 2017. Find the full list of signatory countries and jurisdictions here.

Multilateral Instrument (MLI)

The MLI enables all signatories to meet their treaty-related minimum standards under the OECD/G20 BEPS project for the prevention of treaty abuse, for the improvement of dispute resolution, for a strengthened definition of permanent establishment and measures on hybrid mismatch arrangements. Please find the full text of the MLI here in English, in French or in German (unofficial). An explanatory statement provides more clarity on the MLI.

The MLI provides the flexibility to accommodate the positions of various countries. For example, countries may choose which existing tax treaties they would like to be modified by the MLI. Once a tax treaty has been listed by the two treaty partner countries, the treaty becomes an agreement to be covered by the MLI ("Covered Tax Agreement"). The OECD reports that the 68 signatories have listed 2,362 treaties that, in turn, have already resulted in over 1,103 matching agreements. Luxembourg has chosen all of its 81 tax treaties to be modified by the MLI. It is noteworthy that the United States has not signed the MLI.

The MLI does not override or amend existing bilateral tax treaties – as an amending protocol does – but is applied alongside the Covered Tax Agreements, modifying their application in order to implement BEPS actions. As the MLI is the first multilateral treaty of its kind, a legal note has been prepared by the OECD to explain the functioning of the MLI under public international law.

The main choices made by Luxembourg, i.e. the main options and reservations made at the date of signature of the MLI, are summarised below. In a nutshell, Luxembourg respects the minimum standards, but does not go much beyond. However, Luxembourg, as any other country, may amend its MLI position in the future.

Treaty abuse

To meet the BEPS minimum standard on treaty abuse (BEPS 6), Luxembourg has chosen to include a specific preamble text in all of its tax treaties (except for the treaty with Senegal which already has such a preamble). This preamble contains the express statement to eliminate double taxation without creating opportunities for reduced taxation or non-taxation. The preamble also states the desire to enhance co-operation on tax matters.

Luxembourg (as all other signing countries) has chosen to include the principal purpose test (PPT) in all of its tax treaties (except for the treaty with Senegal which already includes this test). While the PPT will apply to all treaties covered by the MLI, the OECD mentioned that an additional Simplified Limitation on Benefits test will only apply to the treaties of 12 jurisdictions, including Argentina, Armenia, Bulgaria, Chile, Colombia, India, Indonesia, Mexico, Russia, Senegal, the Slovak Republic and Uruguay.

Dispute resolution

Luxembourg has chosen to apply the minimum standards for making dispute resolution mechanisms more effective (BEPS 14).

Furthermore, Luxembourg has opted in for the mandatory binding arbitration together with the following signatories: Andorra, Australia, Austria, Belgium, Canada, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Liechtenstein, Malta, the Netherlands, New Zealand, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the United Kingdom.

This will lead to the introduction of arbitration to over 150 existing treaties. A taxpayer may request a mandatory binding arbitration if the competent authorities were not able to reach a mutual agreement within two years. Luxembourg, like most of the countries, has opted for the default option of final offer arbitration (also referred to as "baseball arbitration"): Each competent authority will submit a proposed resolution addressing all issues under review to the arbitration panel which selects one of the proposed resolutions as its decision.

Permanent establishment

Changes to the permanent establishment (PE) definition developed through the work on BEPS 7 were not a minimum standard.

Therefore, Luxembourg has decided <u>not</u> to further expand the definition of PE to commissionaire arrangements or similar strategies to include situations in which the dependent agent "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise."

To prevent artificial avoidance of PE status, Luxembourg has chosen to apply <u>Option B</u> for the specific activity exemption. Thus, certain activities may be carried out in a given treaty country without creating a PE irrespective of whether the activity is of a preparatory or auxiliary character. In this context of specific activity exemptions, Luxembourg will <u>not</u> apply the anti-fragmentation rule.

Furthermore, Luxembourg will <u>not</u> prevent artificial avoidance of a PE through splitting up contracts.

Hybrid mismatches

Luxembourg has made one reservation as regards transparent entities and reserved the right <u>not</u> to apply the MLI provisions for dual resident entities. For the application of methods for elimination of double taxation, Luxembourg has chosen <u>Option A</u> to address problems arising from the inclusion of the exemption method in treaties with respect to items of income that are not taxed in the source state.

Tools and guidance

The OECD continues to develop tools and guidance on the MLI and recently has provided the following documents on its website:

- Information brochure
- List of "frequently asked questions" (FAQs)
- MLI application toolkit

The OECD expects to launch a public online matching tool. The first part of the tool will be made available after all the data from the various countries' MLI positions has been carefully processed and analysed. The tool will then be expanded and refined over the next couple of years, for example to include detailed information on the timing of the modifications made by the MLI.

Next steps

The MLI will only enter into force three months after five countries have ratified, accepted or approved it. Once ratified, the MLI provisions chosen can potentially apply to all the Covered Tax Agreements specified by the countries, although a specific Covered Tax Agreement will only enter into force after the parties to that treaty have ratified the MLI. The OECD expects the first modifications to covered treaties to become effective during the course of next year.

KPMG Luxembourg comment

As noted by finance minister Pierre Gramegna, Luxembourg again confirms its commitment to tax transparency and implementation of BEPS actions by being an early adopter of the MLI.

The signing of the MLI is seen as a catalyst for action by taxpayers who need to quickly assess how particular treaties will change, evaluate how and when their operations might be affected, and develop plans to address that impact. The practical effects of its implementation will, however, depend on the choices and reservations made by the signatories and how tax administrations apply the new provisions in practice.

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