Werner Haslehner

Reforming the International Tax System

The Need for Reform and Implications of the OECD BEPS-initiative for Luxembourg

It is at the same time trivial and difficult to define the problem of the current international tax system. Public inquiries and media reports have successfully exposed particularly egregious examples of the international tax system's unsatisfactory results: It has become clear that multinational enterprises are capable of using the existing rules to significantly reduce their tax burden in any given country and thus avoid contributing their "fair share" to the financing of the states that allow them to thrive. The OECD has labelled such exploit of the international tax system "Base Erosion and Profit Shifting", which, in the form of its acronym "BEPS" has become the embodiment of the debate concerning the best way to address its failure. The OECD "BEPS-initiative" attempts to achieve an unprecedented overhaul of a body of international law that is based on a consensus that dates back almost an entire century and today is embodied in over 3 000 treaties concluded by countries spanning the globe.

BEPS generally refers to arrangements that legally[1] move profits to countries where they are taxed at lower rates (or not at all) and shifting of expenses to countries, which provide relief for these at higher rates ('profit shifting'). Such activity results in a loss of tax base ('base erosion') of those countries that impose higher tax rates. In principle, that outcome could be seen as an unavoidable consequence of the incentives created by different legal frameworks – a harmless, maybe even healthy consequence of competition between countries for investment. While this view is certainly sometimes advocated, it becomes less convincing when it is clear that the shifting of profits happens in a way that is disconnected from economic reality and the creation of value through business activity; if a country's tax revenue no longer depends on the economic activity it allows and supports, but can be changed upon the stroke of a pen of business owners and managers.

A system that allows certain taxpayers to arrange their affairs in such a way as to defeat its purpose and thus both economically and politically distort the outcome intended by legislators is in need of serious reform

It is easy to understand that a system that allows certain taxpayers to arrange their affairs in such a way as to defeat its purpose and thus both economically and politically distort the outcome intended by legislators is in need of serious reform, not only to restore fairness and a level-playing field between multinational enterprises, national enterprises and "ordinary taxpayers" (mostly employees), but arguably also to safeguard the sovereignty of countries, which may be effectively undermined by their inability to effectively determine the level of taxation they wish to impose on entities that are active within their jurisdiction.[2] But it is much more difficult to appreciate what causes the international tax system to fail in such a way. Indeed, several elements together seem to be responsible. Primary suspects are

1. the **lack of coordination of domestic tax rules,** which result in varying characterisations of entities, payments and ultimately different assumptions of tax jurisdiction,
2. **flaws of the existing international rules** that rely too much on legal constructs rather than economic substance which are not aligned with the realities of the modern business world and
3. practical **problems of enforcement** of existing laws **due to asymmetries of information and resources** between

Werner Haslehner is Associate Professor for European and International Tax Law at the University of Luxembourg.

multinational enterprises and tax authorities, corroborated by incomplete exchange of information between countries.

It is no coincidence that the BEPS-initiative has identified these three elements as the main pillars for its proposed reforms: Ensuring *coherence* in the interaction of domestic (corporate) tax laws, realigning taxation with *substance* and improving *transparency* in the international tax system.

BEPS Actions and their Importance for Luxembourg

The initial drive to reform the international tax system came from the leaders of the world's biggest economies, the G20, which urged all countries to cooperate especially with respect to an effective exchange of information and called on the OECD to take the lead in devising an action plan to tackle base erosion and profit shifting. Following a first report that identified the international tax system's failings in the beginning of 2013, the OECD later that year published a detailed "Action Plan", in which it outlined 15 separate "action items" to reform key pressure points in the system in order to address the tax base erosion problem.

Of these 15 action items, the OECD addressed seven in yet more concrete reports before the end of 2014, with the remaining work scheduled to be completed by the end of 2015. Of the first group of actions, the following three appear particularly relevant for Luxembourg due to the disproportionate importance of the financial services industry for its economy. It is important to keep in mind, however, that these are by no means all proposals that are likely to have an impact on Luxembourg and its economy.

Action Item 2: Neutralising the Effects of Hybrid Mismatch Arrangements

"Hybrid mismatches" as defined by the OECD exist in two different forms, which are characterised by their effects in the domestic laws of at least two countries: They can either be in the nature of a "deduction-non inclusion" mismatch or in that of a "double deduction" mismatch. In the first case, a payment that flows out of country A to a company in country B will be deductible in country A and thus reduce the tax base in that country, without being included in the tax base of country B. In the second case, a payment is treated as deductible under the rules of both country A and B. The result in both cases is identical: the portion of income that is transferred through such payment remains untaxed in both jurisdictions. Despite this, it is not obvious that such an arrangement hurts any particular country, as both could decide unilaterally to impose a tax on that portion of income, but they do not. The OECD recognizes that "it may sometimes be difficult to determine which individual country has lost tax revenue",[3] but it is still easy to see why countries have a legitimate interest to prevent such result through cooperation: both can potentially gain from cooperation and the companies in question are not prima facie put at a disadvantage compared to competitors that cannot avail themselves of such tax planning strategy, for instance because they operate solely within one country.

Luxembourg's "IP regime" is clearly not in line with that condition and would thus appear likely to be considered a "harmful tax practice".

However, instead of encouraging direct cooperation among countries through bilateral or multilateral agreements, the OECD report suggests to harmonise domestic tax law through the adoption of two rules: a "primary" rule, under which the country where a payment arises would not allow a deduction if the recipient country does not include said payment in its tax base as ordinary income; and a secondary "defensive" rule, under which the recipient country would tax any payment that has been deducted in the payment state as ordinary income. The second would only apply in case the paying state did not apply the "primary" rule, thus creating an order of both rules that ensures the resolution of mismatches without creating double taxation, even in cases where only one of the countries actually adopted the OECD's recommendation. In practice, this may not always be achieved, however, especially in complex cases involving more than two countries. There are several worries with this approach, especially the requirement to assess the tax rules applicable in any other country that a payment may be made to, which represents not only a practical difficulty (especially for small or developing countries due to the smaller size of their tax administration), but also a deviation from the key insight of the initiative that the response to BEPS should be based on real collaboration rather than unilateral (though uniform) measures.

The report of the OECD on Hybrid Mismatch Arrangements creates a challenge for Luxembourg, although it is certainly not insurmountable: the use of so-called hybrid financial instruments that create the effects criticised by the OECD is widespread for investments from outside the EU, but is mostly absent within the EU, where recent changes to the Parent-Subsidiary Directive are explicitly tackling the same issue. While the introduction of linking rules as proposed by the OECD would lead to an increased administrative burden and might affect existing investments, it appears unlikely to have a significant impact on Luxembourg's economy.

Action Item 5: Countering Harmful Tax Practices More Effectively

In its (interim) report on Action Item 5, the OECD builds on its earlier work done within the Forum on Harmful Tax Practices, with yet little innovation compared to the 1998 Report on Harmful Tax Competition. It relies on the same four key factors to identify a "harmful tax practice": whether a tax regime results in "no or low effective tax rates on income from geographically mobile financial and other service activities", it is "ring-fenced from the domestic economy", "lacks transparency" and there is "no effective exchange of information with respect to the regime". Action Item 5 adds a "substantial activity requirement" for any preferential regime and discusses this condition in particular with respect to special regimes applying to income from intangibles ("IP regimes"). The OECD has not yet finalised the test

it will eventually propose to apply to determine whether a preferential regime requires "substantial activity" and is thus acceptable; but it expresses a clear preference for the so-called "nexus approach". Under this approach, a tax reduction may not be granted for income that is not directly linked to activity that has created the income-generating asset. In practice, this means that a lower tax rate for income from intellectual property is only acceptable in the eyes of the OECD to the extent that such income is directly linked to a patent (or similar asset) the creation of which is based on expenses incurred by the entity holding the patent within the jurisdiction applying that tax regime.

Luxembourg's "IP regime"[4] is clearly not in line with that condition and would thus appear likely to be considered a "harmful tax practice". The OECD has not spelt out the consequences of such label, but it will most likely be confined to political pressure to change or abolish the regime. It is not yet clear whether the OECD's approach can actually be applied within the EU, as the Court of Justice may view a requirement to undertake research within national boundaries in order to access tax benefits as a restriction of the European market freedoms.[5] The relationship between the BEPS project and EU law is complicated, however, the institutions are actively involved in complementing the effort of the OECD, in particular with respect to exchange of information rules. At the same time, Luxembourg's as well as other Member States' IP regimes are under scrutiny by the Commission as to their compatibility with State Aid rules, the outcome of which is as of yet also unclear. The Luxembourg tax authorities are wary of the consequences; it is understood that they would not give advance confirmation of the applicability of the IP regime unless a taxpayer could show substantial activity in connection with IP.

Action Item 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

The third action with potentially big impact on Luxembourg concerns the availability of tax treaty benefits to entities under what the OECD identifies as "inappropriate circumstances". The report recommends that countries include two specific rules in their tax treaties that would lead to a denial of its benefits – especially the elimination or reduction of withholding taxes in countries of investment. The first of these two rules (the "LOB"[6] provision) is highly technical in nature, but in essence would require that a Luxembourg company either undertakes "active trade and business" in Luxembourg, is listed on a recognized stock exchange or is in the majority owned by Luxembourg residents. These requirements may be difficult to fulfil for many if not most holding companies currently operating in Luxembourg, which could result in unacceptable cost disadvantages for international groups seeking to consolidate their group structure through a holding company here. For a small, open economy, a requirement that most members or shareholders of a company be resident within that economy is a particularly harsh condition. It also seems to go against the idea of a free capital market, which the EU treaties protect against restrictions. As with the previous action, it is questionable whether the inclusion of the recommended LOB rule would be compatible with EU law. For Luxembourg, avoiding the project to have a devastating impact on its investment fund industry is even more important than the protection of holding companies with genuine economic activity here. While those funds that qualify as "collective investment vehicles" – widely held, diversified and nationally regulated funds – will most likely be excluded from the scope of the final provision, the OECD has yet to finalise its recommendations concerning alternative fund structures, including private equity funds.[7] It will be crucial for Luxembourg to have its voice heard in the on-going consultation procedure in this regard.

The second rule proposed by the OECD as complementary to the LOB rule is a very broad general anti-avoidance rule that would give tax authorities a wide margin of discretion to deny treaty benefits to tax authorities whenever "it is reasonable to conclude … that obtaining [a treaty] benefit was one of the main purposes of any arrangement or transaction".[8] Because of its very wide scope, this rule may be used not only to fight genuine tax avoidance schemes, but could equally impact genuine business strategies which are legitimately seeking to reduce their tax burden within the purpose of the applicable law. As with the first rule, this again raises particular questions with respect to its compatibility with EU law.

Luxembourg's Response

The government of Luxembourg has repeatedly expressed its support for the BEPS initiative, while "[i]nsisting on the importance to preserve the advantages of cross-border activities and investments".[9] In a meeting at the OECD in Mai 2013, the then Finance Minister of Luxembourg, Luc Frieden, officially pledged Luxembourg's support for the OECD's project, but maintained the need for tax competition to encourage growth, identifying the challenge for the OECD in "redefining tax planning in the spirit of fairness".[10] As many other countries, Luxembourg is willing to contribute to the OECD's project to increase the chances of having its views and concerns taken into account, but is cautious about the ultimate outcome.

This cautious approach stands in marked contrast to the more proactive approach of the current government towards parallel initiatives launched by both the OECD and the EU Commission to tackle issues related to tax evasion: Following increased pressure from the Global Forum on Transparency Exchange of Information, Luxembourg lifted its bank secrecy rules for purposes of tax information exchange in 2010 and further reduced possibilities for taxpayers to challenge such exchange in November 2014. It furthermore committed and adopted wide-ranged automatic exchange of information within the EU. In response to the EU Commission's enquiries into Luxembourg's ruling practice and application of the "arm's length standard" for the determination of prices charged between related companies, it formalised both previously less clearly regulated issues in statutory law. It comes as no surprise that Luxembourg's response has been different in the latter cases in comparison to the reaction to the BEPS project's (preliminary) recommendations: One the one

hand, the EU wields far stronger influence over Luxembourg than the OECD due to the binding rules of the EU treaties; on the other, its demands are easier to comply with because they are more clearly defined and they are such as not to significantly constrain Luxembourg's ability to attract foreign investment.

Implications of the BEPS-Initiative for Luxembourg

It is difficult to predict the effects the BEPS project may eventually have on Luxembourg, as the project's final outcome is still uncertain. However, certain risks can clearly be identified, in particular with respect to the existing law and status of the economy with its high reliance on foreign investment in financial services. The above-described action items may have a negative effect on such investment flowing to Luxembourg to the extent that they aim at neutralising structures that can currently be used to reduce the tax burden on cross-border investment. It seems unlikely, however, that the introduction of anti-mismatch rules to prevent "double non-taxation" will have a significant impact, especially if these are successfully employed as a global standard. The focus on increasing substantial activity poses a challenge to certain investment structures that currently operate with little substance in Luxembourg. However, the same also represents an opportunity for Luxembourg to attract more substantial activity and gain investment at the expense of tax haven jurisdictions where the required level of substance cannot reasonably be achieved. The BEPS discussion regarding the limitation of treaty benefits has maybe the clearest potential to hurt the holding and fund industry in Luxembourg, but discussions on that item are still under way and several questions, including the conformity of the most restrictive proposals with EU law, are yet to be answered. ◆

A longer version of this text has been published in Caritas, Sozialalmanach 2015.

1 It is important to recognize that none of the actions the initiative addresses amount to tax evasion, which is the technical term reserved for conduct that results in an illegal reduction of the amount of tax to be paid. Profit shifting as addressed by the BEPS initiative only concerns legal arrangements; these may or may not run counter to the intentions of the legislators of the rules that are used, but they do not violate them.

2 It should be noted here that this is of even greater concern to developing and emerging economies with comparably less sophisticated and resourceful tax administrations than OECD countries, which – despite their lead in the project – may thus not be the biggest beneficiaries of the outcome.

3 OECD (2014): *Neutralising the Effects of Hybrid Mismatch Arrangements,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, URL: http://dx.doi.org/10.1787/9789264218819-en (13 March 2015), p. 11.

4 Article 50bis Loi concernant l'impôt sur le revenu (L.I.R.) exempts 80% of the income derived from certain types of intellectual property and contains no requirement that the intellectual be created in Luxembourg.

5 There is a precedent for this, in Case C-39/04, Laboratoires Fournier, ECLI:EU:C:2005:161, where the Court denied the right of France to limit a tax credit for research to activities undertaken in France.

6 "LOB" stands for "Limitation on Benefits". The only notable tax treaty concluded by Luxembourg to date with such a rule is the tax treaty with the United States, which generally aims to include these in its treaties.

7 OECD (2014): Public Discussion Draft – Follow Up on BEPS Action 6: Preventing Treaty Abuse (21 November 2014), URL: http://www.oecd.org/ctp/treaties/discussion-draft-action-6-follow-up-prevent-treaty-abuse.pdf (13 March 2015)., pp. 4-7.

8 OECD (2014): *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances,* p. 66.

9 Statement by Luc Frieden, press release of the Luxembourg Ministry of Finance (30.04.2013), URL: http://www.mf.public.lu/actualites/2013/04/frieden_statement_ft_300413/index.html (13 March 2015).

10 Le Luxembourg plaide pour une taxation effective qui est nécessaire pour une concurrence fiscal saine et transparente auf sein de l'Union européenne et dans le monde, press release of the Ministry of Finance (10.06.2013), URL: http://www.mf.public.lu/publications/q_a/fiscalite_multin_100613.pdf (13 March 2015).