Managing substance in pandemic times

by Oliver R. Hoor

Tax Partner (Head of Transfer Pricing & the German Desk)

with ATOZ Tax Advisers

LPEA

THE LUXEMBOURG VOICE OF PRIVATE CAPITAL

Table of Contents

Luxembourg is a major hub for the structuring of private equity investments in and through Europe. Private equity investments are typically structured via a Luxembourg or a foreign fund and Luxembourg companies that acquire businesses. This article analyses potential issues relating to the management of substance during the COVID-19 crisis and provides practical recommendations for taxpayers.

1. Introduction

The outbreak of COVID-19 has resulted in an unprecedented crisis that requires the adoption of radical measures by governments to limit the uncontrolled spread of the virus among the population. Many States in Europe and the rest of the world, have announced travel restrictions and the requirement of "social distancing".

As part of a series of measures to cope with the COVID-19 situation, the Luxembourg government provides flexibility with respect to the holding of shareholder and board of director meetings without the need of physical presence.[1] However, all the measures adopted in Luxembourg and abroad may have a very practical impact on the substance of Luxembourg companies.

It should also be considered that depending on how the current COVID-19 pandemic develops, it cannot be excluded that this situation may last for several months. Given that governments follow different strategies to deal with the containment and management of the disease, it can further not be excluded that some jurisdictions will experience a more severe and lasting situation until this is under control, resulting in extended travel restrictions.

2. Potential substance issues in the COVID-19 crisis

The notion of substance is a multi-dimensional concept which involves different aspects such as infrastructure (office premises, IT equipment, etc.), the functional and risk profile (functions performed, risks assumed, etc.) and, notably, the corporate governance of companies. Substance is a key element in international taxation and relevant for the application of domestic tax law, tax treaties and the arm's length principle.

The Luxembourg government has issued a Grand-Ducal Regulation on 20 March 2020 which provides for a number of emergency measures that are meant to mitigate the immediate effects of the COVID-19 crisis and to ensure business continuity. With regard to the governance of Luxembourg companies, the Regulation allows shareholder and board meetings without physical presence.

Accordingly, meetings of the board of directors, board of managers and supervisory boards may be held, and resolutions be passed, by way of written circular resolutions or video conference (or any other means of telecommunications allowing the identification of participants). Likewise, shareholder meetings may be organized remotely (by a vote in writing or in electronic form), through a proxy appointed by the company or by video conference (or other means of telecommunication allowing the identification of participants).

This emergency system will thus allow the bodies of any company or legal person to be able to hold their meetings without requiring the physical presence of their members while guaranteeing their effective participation and the exercise of their rights. Participants through such means will be considered present for the purposes of determining the quorum and majorities.

[1] Article 12 of the Règlement Grand-Ducal of 18 March 2020.

Moreover, with regard to the holding of the annual general meetings, companies and other legal persons may convene such meetings on a date which falls 6 months after the end of their financial year or until to 30 June 2020 notwithstanding any contrary provision in the company's articles of association.

While it is very welcome that the Luxembourg government reacted so quickly, businesses should carefully evaluate how reliance on these simplification measures may be detrimental in terms of substance, in particular if this crisis lasts for several months. Another issue relates to the circa 200,000 frontier workers which are now restricted in their ability to commute to Luxembourg, potentially working remotely from their home office.

The organisation of meetings of the board of directors in a remote fashion generally weakens the substance of Luxembourg companies. In the extreme, foreign tax authorities may claim that the place of effective management is in their territory if the directors are resident (and self-isolated) therein. Depending on how long the situation will last, it can also not be excluded that foreign tax authorities will try to apply anti-abuse legislation (for example, denial of a withholding tax exemption on grounds of a lack of substance). Last but not least, depending on how directors and employees manage activities on behalf of the Luxembourg company, foreign tax authorities may construe the existence of a permanent establishment which would create a taxable nexus in the foreign jurisdiction.

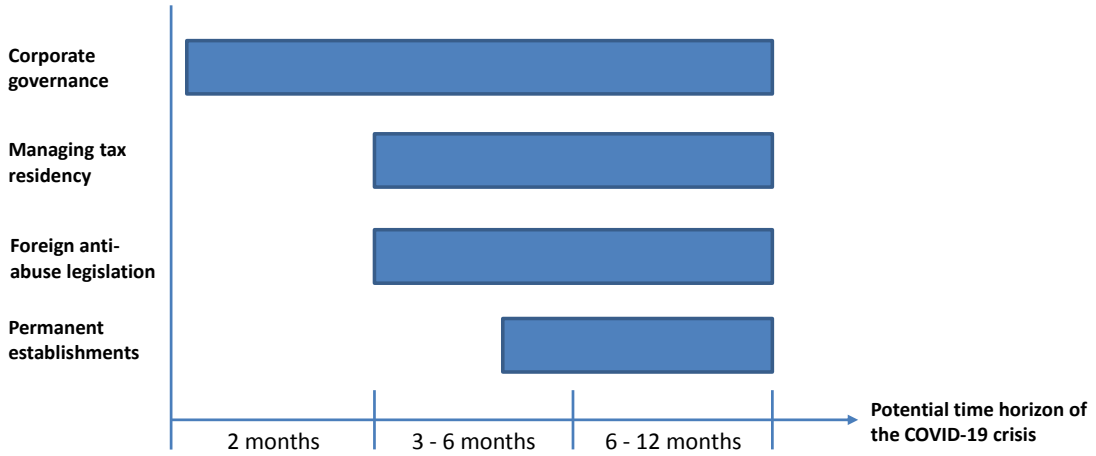
It is interesting to note that France, Belgium and Germany agreed to not consider the COVID-19 home working days when determining a potential tax liability of their residents with respect to income from employment[2] (derived from Luxembourg sources). However, no such clarification has yet been provided in regard to the other areas of tax risks (for example, the application of anti-abuse legislation and the constitution of permanent establishments).

On 3 April 2020, the Organisation of Economic Co-operation and Development ("OECD") Secretariat released, at the request of concerned countries, its analysis of potential tax issues linked to telework, individuals that are stranded in a country that is not their country of residence and travel restrictions. The main topics considered in the OECD paper include the potential impact on the tax residency of companies, potential permanent establishment issues and tax issues of cross-border workers.

[2] The three neighbouring countries of Luxembourg adopted a safe harbour of respectively 19 (Germany), 29 (France) and 24 (Belgium) days per year up to which resident taxpayers are not taxable on their income of employment when working from home or in a third state. Once the threshold is exceeded, the income from employment should be taxable in the residence state of the employee on a pro-rate basis.

The following chart depicts the potential tax issues depending on the period of the lockdown and (compulsory or voluntary) travel restrictions:

Potential substance issues in the COVID-19 crisis



3. Managing tax residency

From a Luxembourg tax perspective, a company is considered tax resident if its statutory seat or its central administration (that is the place of effective management) is located in Luxembourg.[3]

A key risk which requires careful management is that a Luxembourg company is considered to be tax resident in another country by virtue of the effective management being exercised within the territory of that country. In case of dual residency, tax treaties concluded by Luxembourg provide that the State of residence for tax purposes will be in the country in which the company is effectively managed (i.e. the so-called tie-breaker rule).[4] When a Luxembourg company is deemed to be resident in another jurisdiction, the company may be subject to taxation on its worldwide income in this other jurisdiction.[5]

It is therefore critical that all important strategic and commercial decisions which are necessary for the conduct of the company's business are actually taken in Luxembourg. Accordingly, the board meetings of a Luxembourg company should be held regularly in Luxembourg with the physical presence of all appointed directors.[6] The frequency of the meetings of the board of directors should be commensurate with the level of activities performed by the Luxembourg company.

The board of directors should be (partly) composed of qualified Luxembourg resident directors who are in a position to exercise a management function and should be seen to do so in the documentation of business transactions. While non-residents may make strategic recommendations to the board of directors, the directors must independently appraise each

[3] Article 159 of the LITL.

[4] The country in which the place of effective management of a company is located should be considered as the State of residence (which may tax all the income realized by a company) whereas the other Contracting State may only exercise taxing rights in relation to income sourced in its territory (to the extent the source State has a right to tax under the tax treaty).

[5] Such tax residency challenge may be particularly problematic in a fund context when a Luxembourg company is the general partner of a fund as this may jeopardize the tax residency of the company and the fund.

[6] Any non-Luxembourg resident board members meeting abroad to take/implement decisions without the involvement of the Luxembourg resident directors need to be avoided.

proposal and not merely "rubber stamp" the recommendations. The board meetings should be properly documented in meeting minutes.

Given that it is currently (and potentially for an extended period) not possible for non-resident directors to travel to Luxembourg, it should be considered how the tax residency of Luxembourg companies can be properly managed during this period. When a board of directors is for example composed of two Luxembourg directors[7] and two non-resident directors, it might be considered that the non-resident directors give a proxy to the Luxembourg resident directors so that all the decisions can be taken by the Luxembourg resident directors on Luxembourg soil. The board of directors meeting may nonetheless be organized remotely, for example by video conference. While it should not be harmful if all the directors participate to the video conference, the non-resident directors should merely observe the meeting of the board of directors.

When determining the optimal course of action, it should be analysed on a case-by-case basis what is the composition of the board of directors, where the non-resident directors are resident for tax purposes and how many board meetings will need to be organized in the months to come. Depending on the situation, it might also be considered to temporarily adjust the composition of the board of directors (for example, appointing an additional Luxembourg director to the board).

According to the OECD, it is unlikely that the COVID-19 situation will create any changes to an entity's residence status under a tax treaty. A temporary change in location of the chief executive officers and other senior executives is considered as an extraordinary and temporary situation due to the COVID-19 crises and such change of location should not trigger a change in residence (in particular, when the corporate tie-breaker rule is applied). According to the OECD, all relevant facts and circumstances should be examined to determine the "usual" and "ordinary" place of effective management, and not only those that pertain to an exceptional and temporary period such as the COVID-19 crises.

Thus, when analysing potential tax risks, it might also be worth to consider how robust corporate governance was in the past. With a best in class approach, the exceptional situation in the COVID-19 environment should not give rise to any significant tax risks. However, in other cases, this might be the right moment to reconsider the management of corporate governance.

4. Foreign anti-abuse legislation

A lack of substance may in general trigger the application of foreign anti-abuse legislation. Many countries in Europe and around the globe have adopted different types of anti-abuse rules in their domestic tax law. Anti-abuse legislation ranges from general anti-abuse rules (GAAR) to provisions that target specific situations of abuse. These rules have in common that they generally subject the recognition of foreign companies or the granting of tax benefits to the condition that certain substance requirements are fulfilled.

As an example, many European Member States implemented anti-Directive/treaty shopping rules in their domestic legislation according to which a foreign company can only claim a reduced or zero withholding tax rate on dividends, interest and royalty payments in accordance with EU Directives (i.e. the EU Parent/Subsidiary Directive, "PSD" and the EU Interest and Royalty Directive) or tax treaties if the recipient of the income fulfills specific substance requirements. In many cases, such legislation employs the concept of beneficial ownership according to which reduced or zero withholding tax rates are only applicable if the recipient of the income is the beneficial owner thereof.

[7] Luxembourg directors include individuals that are living abroad and who commute to work in Luxembourg. The latter are deemed to be professionally resident in Luxembourg.

The OECD is currently advocating coordinated measures regarding taxation in the COVID-19 crisis. Given that the current situation is not a choice of the taxpayer but a consequence of the travel restrictions and self-isolation policies imposed by governments this can be seen as a force majeure event and should not trigger the application of anti-abuse legislation (even though the OECD paper of 3 April 2020 is silent regarding the (non-)application of anti-abuse rules).

However, it would still be wise for Luxembourg companies to minimize foreign tax risks. The measures mentioned regarding the management of Luxembourg tax residency should also be helpful in order to exclude the potential application of foreign anti-abuse legislation.

5. Avoiding unintentional permanent establishments

Another topic that may become relevant is unintentional permanent establishments. When directors or employees of a Luxembourg company work for an extended period of time in their home jurisdiction on behalf of a Luxembourg company, foreign tax authorities may argue that a permanent establishment is constituted in their territory.

According to Article 7 of the OECD Model Tax Convention, a Contracting State cannot tax business profits of enterprises resident in the other Contracting State unless it carries on its business through a permanent establishment located therein. In contrast, when a permanent establishment is constituted in a Contracting State, the income that is attributable to the permanent establishment may be taxed in the host State thereof.[8]

The constitution of a permanent establishment means that the Luxembourg company would have a taxable nexus in another jurisdiction. This creates significant administrative burden and gives rise to tax risks. Whenever a permanent establishment is constituted, the question arises as to how much profits should be attributed to the permanent establishment. Here, taxpayers and tax authorities may have diverging views. In the past, the tax authorities of some jurisdictions tried to extensively rely on the permanent establishment concept to challenge the tax position of Luxembourg companies.

Article 5 (1) of the OECD Model Tax Convention defines the term "permanent establishment" as a "*fixed place of business through which the business of an enterprise is wholly or partly carried on*". Hence, the definition of a permanent establishment contains the following conditions:

- the existence of a "place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be "fixed", i.e. it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business.

The term place of business has a broad definition and covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. These may be owned, rented or otherwise at the disposal of the enterprise and may even be situated in the business facilities of another enterprise. Therefore, a home office of a director or employee may come within the scope of fixed place of business.

The business of an enterprise is carried out mainly by the entrepreneur or personnel (i.e. persons who are in a paid employment relationship with the enterprise) including employees and other persons receiving instructions from the enterprise (for example, dependent agents). The powers of such personnel with regard to its relationships with third parties are irrelevant.

[8] The attribution of profits to a permanent establishment should be consistent with the arm's length principle.

Therefore, when the directors and/or employees of Luxembourg companies are frequently present in foreign jurisdictions (in their capacity as directors or employees of the Luxembourg company), it is recommended to determine guidelines in order to not create a presence in another jurisdiction that could give rise to a permanent establishment (assuming that this is not part of the business strategy).

It is interesting to note that the permanent establishment definition provided in Article 5 of the OECD Model received a lot of attention during the OECD Base Erosion and Profit Shifting ("BEPS") Project. Action 7 of the BEPS Project (Preventing the artificial avoidance of permanent establishments) aimed at developing an amended definition of permanent establishment in order to tackle the (perceived) avoidance of permanent establishment status.

The work of the OECD resulted in a reduced threshold for the constitution of a permanent establishment. While changes to the permanent establishment definition in bilateral tax treaties could be implemented via the Multilateral Instrument ("MLI"), Luxembourg mainly adhered to the minimum standard. Hence, these changes should have no immediate impact on Luxembourg companies.

According to the OECD paper, it is unlikely that the COVID-19 situation will create any change to a permanent establishment determination in a tax treaty context. Here, the exceptional and temporary change of the location where employees exercise their employment because of the COVID-19 crisis, such as working from home, should not create new permanent establishments for businesses to the extent that it does not become the new norm over time. However, it is also recognised that the threshold presence required by domestic law to register for tax purposes may be lower than those under a tax treaty and may therefore trigger corporate income tax registration requirements.

Hopefully, all countries will follow the positions of Ireland and Australia that already clarified that the unplanned presence of employees as a consequence of COVID-19 should not result in the constitution of a permanent establishment. Nonetheless, when analyzing potential permanent establishment risks, taxpayers should also consider the situation before and after the COVID-19 crisis.

6. Conclusion

The Luxembourg government adopted a COVID-19 emergency package that also includes some simplification measures regarding the holding of shareholder and board of director meetings. Nevertheless, the way corporate governance is managed has an impact on the substance of Luxembourg companies.

As a tendency, the longer the current situation will last, the more problematic it will be in terms of substance. The experience from China and other Asian countries shows that it might be possible (with radical measures) to contain the virus within a 2 to 3 months period. However, the virus arrived in different countries at different times and it remains to be seen how successfully each individual country will be in the fight against COVID-19. It can further be expected that travel restrictions (be they compulsory or voluntary) may last even longer.

The OECD Secretariat has issued useful guidance according to which the exceptional and temporary change of the location of senior executives or the location where employees exercise their employment should be considered as a force majeure and generally not trigger adverse tax consequences.

Ultimately, taxpayers should analyse potential tax risks linked to the lockdown and implement, where necessary, mitigation strategies. Here, it would be wise to also consider the substance before and after the COVID-19 crisis. The hope is, however, that foreign tax authorities will take a reasonable stance in these extraordinary circumstances. As they say, hope for the best and prepare for the worst!

Oliver R. HOOR is a Tax Partner (Head of Transfer Pricing and the German Desk)
with ATOZ Tax Advisers (Taxand Luxembourg).

The author may be contacted at:
oliver.hoor@atoz.lu

The author wishes to thank Samantha Schmitz (Chief Knowledge Officer) for her assistance.

www.atoz.lu