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Luxembourg: Impact of the PPT on Alternative Investments

Oliver R. Hoor and Keith O'Donnell
ATOZ Tax Advisers (Taxand Luxembourg)

Luxembourg is a prime location for the structuring of alternative investments in and through Europe: its extensive tax treaty network is a contributing factor to the country's attractiveness to international investors. What effect will the PPT have on alternative investments structured via Luxembourg and what limitations have been imposed by recent cases of the CJEU?

Oliver R. Hoor, Tax Partner, and Keith O'Donnell, Managing Partner, ATOZ Tax Advisers (Taxand Luxembourg)

On December 18, 2017, the 2017 Update to the OECD Model Tax Convention (the "OECD Model") and the related Commentary were released. The 2017 Update also includes guidance on the interpretation of the Principal Purposes Test ("PPT") in a non-CIV fund context. This guidance is particularly relevant for so-called alternative investments such as private equity, real estate and infrastructure investments. This article analyzes the impact of the PPT on alternative investments structured via Luxembourg and considers the limitations imposed on the PPT by European Union ("EU") law, including recent cases of the Court of Justice of the European Union ("CJEU") that struck down French and German anti-avoidance rules.

Introduction

Bilateral tax treaties are an important and well-established feature of the international tax system. Their main purpose is the promotion of cross-border trade and investment through the allocation of taxing rights between two Contracting States and the determination of mechanisms for the elimination of double taxation. As of today, there are more than 3,000 tax treaties in force around the globe. Though every tax

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treaty is subject to negotiations between the two Contracting States, the majority of tax treaties are fairly similar. This is because the treaty negotiations between the Contracting States are generally based on the OECD Model and are then tailored to the particular economic interest of each Contracting State.

The abuse of tax treaties and, in particular, treaty shopping, has been identified as one of the most important sources of base erosion and profit shifting ("BEPS") concerns within the OECD BEPS Project. Action 6 of the BEPS Action Plan aims at the prevention of perceived tax treaty abuse. The Final Report on Action 6 was released in October 2015 and provides for recommendations regarding the design of tax treaty provisions and domestic tax rules that should prevent the abuse of tax treaties. More precisely, the report proposes a limitation-on-benefits ("LOB") provision, a PPT and a series of specific anti-abuse rules ("SAAR") which would come in addition to existing anti-abuse measures such as the beneficial ownership concept.

Action 15 of the BEPS Project was concerned with the development of a multilateral instrument ("MLI") in order to allow countries to swiftly implement tax treaty-related BEPS measures such as the PPT. While the MLI provided a lot of flexibility, allowing parties (i) to choose the tax treaties that should come within the scope of the MLI, (ii) opting out for (part of) provisions and (iii) choosing to apply optional and alternative provisions, the PPT had to be adopted as a so-called minimum standard measure. Luxembourg is a signatory to the MLI and as such will apply the PPT in its covered treaties. Depending on the speed of ratification by the treaty partners concerned, the PPT will therefore likely become effective starting from 2019 in all covered tax treaties concluded by Luxembourg. In this regard, the 2017 version of the Commentary to the OECD Model will be of significant importance for the interpretation of the PPT.

Luxembourg is a leading global center for investment management, both for investments in traditional assets such as listed shares and bonds, but also in "alternative" investments, a term used to describe investment in assets as varied as private equity, private debt, real estate, infrastructure, etc. Alternative investment strategies often involve more sophisticated structures, reflecting the more complex nature of the underlying assets and thus, the impact of the PPT is of keen interest in this sector.

The Principal Purposes Test

The PPT is included in Paragraph 9 of Article 29 of the 2017 version of the OECD Model and reads as follows:

> Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

Accordingly, the PPT would deny a treaty benefit where it is reasonable to conclude that obtaining this treaty benefit was "**one of** the principal purposes" (emphasis added) of any arrangement or transaction unless the taxpayer is able to establish that granting the benefit would be "in accordance with the object and purpose" of the relevant treaty provisions. However, is a prudent business manager not expected to consider tax as a cost in each and every genuine business transaction? Likewise, are fund managers investing cash on behalf of their investors not obliged to consider and manage the level of taxation as part of their fiduciary duties?

Contradictory Message

The contradictory message of the PPT is that treaty benefits are available to qualifying taxpayers unless taxpayers intend to gain from those benefits. Obviously, this injects a subjective element into every aspect of determining whether treaty benefits are available. The PPT imposes a significant burden on the taxpayer ("establish that the granting of tax benefit would be in accordance with the object and purpose of provision in the convention"), whereas the onus on the tax administration is set at a relatively low level ("reasonable to conclude", "one of the main purposes", "directly or indirectly").

Moreover, according to the Commentary on Article 29 of the OECD Model, the phrase "that resulted directly or indirectly in that benefit" and the terms "arrangement or transaction" should be interpreted broadly. In any case, the threshold to deny treaty benefits in accordance with the PPT is significantly reduced as compared to the previous guidance in the Commentary.

The Commentary emphasizes, however, that it is important to undertake an objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place or being a party to it. It is interesting to note the paradox contained in this undertaking: an objective analysis is made seeking a conclusion on the subjective aims and objects of various persons. It is further stated that it should not be lightly assumed that obtaining a benefit under a tax treaty was one of the principal purposes of an arrangement or a transaction. Furthermore, merely reviewing the effects of an arrangement will not usually enable tax authorities to draw a conclusion about its purposes.

Conversely, a person should not be able to avoid the application of the PPT by merely asserting that the arrangement or transaction was not undertaken or arranged to obtain the benefits of the Convention. In the same vein, the Commentary asserts that obtaining the benefit under a tax convention does not need to be the sole or dominant purpose of a particular arrangement or transaction in order for the PPT to be applicable.

Uncertainty for Taxpayers

Overall, the PPT creates significant uncertainty for taxpayers (and their advisors) because of the unpredictable outcomes, and causes serious concerns for *bona fide* businesses. Holding, financing, IP management and other investment activities are all legitimate and genuine business activities that may fall within the scope of the PPT. In the view of the authors, a PPT-like rule should be designed to tackle only clear-cut

cases of treaty abuse in arrangements that are set up for the predominant purpose of obtaining treaty benefits.

PPT Scope Limited

Crucially, the Commentary limits the scope of the PPT through the statement that a purpose will not be a principal purpose when it is reasonable to conclude that obtaining the benefit was not a principal consideration and would not have justified entering into an arrangement or a transaction that has resulted in the benefit. This limitation in its first part suffers from being somewhat circular: a purpose is not a principal purpose if its consideration was not a principal consideration. However, the second part of the limitation, (i.e., that if the treaty benefit would not justify entering into the arrangement, then the purpose of obtaining a treaty benefit is not a principal purpose), is clearer and may be helpful.

It seems reasonable to conclude that "alternative" investments, where such investments are made for legitimate commercial purposes (generating regular income, maximization of value, etc.) should generally not be in the focus of the PPT, despite the fact that tax implications cannot be completely neglected when investments are structured. The examples given in the commentary to the OECD Model shed a bit more light on such investments and the application of the PPT.

Non-CIV Fund Examples in the Commentary to the OECD Model

Opening Comments

The 2017 Update to the OECD Model and the related Commentary provide for guidance on the interpretation and application of the PPT. In particular, three examples included in the Commentary are of particular relevance when it comes to analyzing alternative investments (i.e., examples K, L and M relating to Paragraph 9 of Article 29).

The Commentary stresses though that when reading the examples, it is important to remember that the application of the PPT must be determined on the basis of the facts and circumstances of each individual case. Furthermore, the examples are meant to be of merely illustrative nature, and should explicitly not be interpreted as providing conditions or requirements that similar transactions must meet in order to avoid the application of the PPT.

A Regional Investment Platform

Example K deals with a situation where a company resident in State R ("RCo") is a wholly-owned subsidiary of a fund that is established, resident and subject to regulation in State T. The fund in this example may refer to different situations such as a private equity fund or a sovereign wealth fund structuring investments via a subsidiary that functions as an investment platform.

It is further stated that RCo operates exclusively to generate an investment return as the regional investment platform through the acquisition and management of a diversified portfolio of private market investments in countries that are located in a regional grouping that includes State R.

The reasons for establishing RCo as a regional investment platform were mainly driven by:

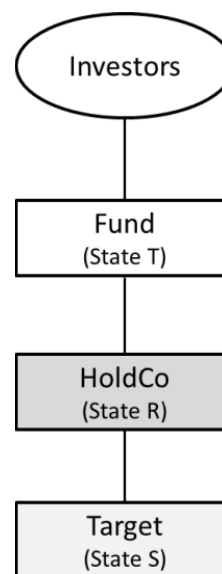
- the availability of directors with knowledge of regional business practices and regulations;
- the existence of a skilled multilingual workforce;
- State R's membership to a regional grouping; and
- the extensive tax treaty network of State R, including a tax treaty with State S which provides for low withholding tax rates.

Regarding the substance of RCo, it is stated that the company employs an experienced local management team to review investment recommendations from the fund and to perform the following functions:

- approving and monitoring investments;
- carrying on treasury functions;
- maintaining RCo's books and records; and
- ensuring compliance with regulatory requirements in the investment jurisdictions.

The board of directors of RCo is appointed by the fund and is composed of a majority of State R resident directors with expertise in investment management, as well as members of the fund's global management team. Moreover, RCo pays tax and files tax returns in State R.

In the example, RCo, which has a portfolio of investments in different jurisdictions in the same regional grouping, contemplates an investment in a company resident in State S. Under the tax treaty between State R and State S, the withholding tax rate on dividends is reduced from 30 percent to 5 percent. In contrast, the tax treaty concluded between State S and State T provides for a withholding tax rate of 10 percent. The following chart depicts the investment structure:



It is explicitly stated that the very fact that RCo considers the existence of a benefit under the State R–State S tax treaty with regard to dividends would not be sufficient to trigger the application of the PPT. The guidance further emphasizes that the intent of tax treaties is to provide benefits for the very purpose of encouraging cross-border investment. Therefore, it would be necessary to consider the context in which

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the investment was made, including the reasons for establishing RCo in State R. As regards this example, it is concluded that it would not be reasonable to deny the benefit of the State R–State S tax treaty unless other facts and circumstances suggest otherwise.

A Securitization Vehicle

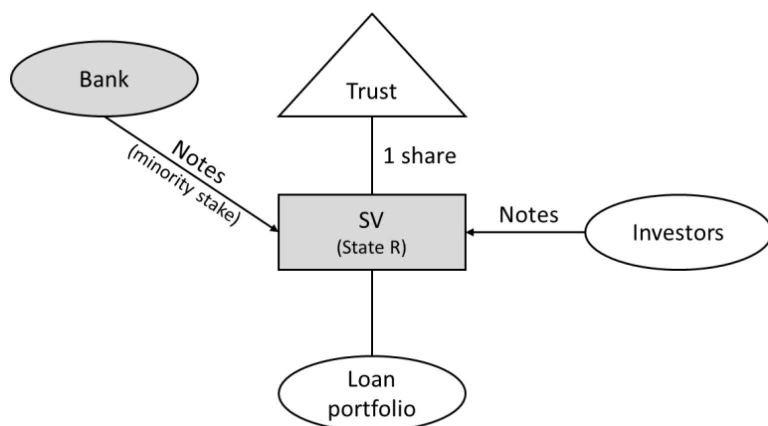
Example L deals with a securitization company ("SV") that has been established by a bank in State R. The bank transferred a portfolio of loans and other receivables owed by debtors located in a number of jurisdictions.

The SV has issued a single share which is held on trust and has no economic value. Otherwise, the SV is fully funded by notes which are widely-held by third-party investors. These notes are listed on a recognized stock exchange which allows for their trading on the secondary market and the notes are held through a clearing system.

The example further states that the bank kept a small percentage of the notes for regulatory reasons. As regards the assets owned by the SV, it is stated that the SV holds 60 percent of its portfolio in receivables of small and medium-sized enterprises resident in State S that generate regular interest payments.

The bank is resident in State T, which has a tax treaty with State S that provides benefits equivalent to those provided under the State R–State S tax treaty, namely a 10 percent limitation of withholding tax on interest (the domestic withholding tax rate applicable on interest in State S would be 30 percent).

The following chart depicts the investment structure:



According to the example, the reasons for establishing the SV were driven by a large number of issues, including:

- the robust securitization framework of State R;
- State R's securitization and other relevant legislation;
- the availability of skilled and experienced personnel and support services in State R;
- the existence of tax benefits provided under the extensive tax treaty network of State R.

It is assumed that investors' decisions to invest in the SV are not driven by any particular investments made by the SV. Moreover, the investment strategy of the SV is not driven by the tax position of the investors. While the SV is subject to tax in State R on its interest income, the interest payments under the notes issued by the SV are fully deductible for tax purposes.

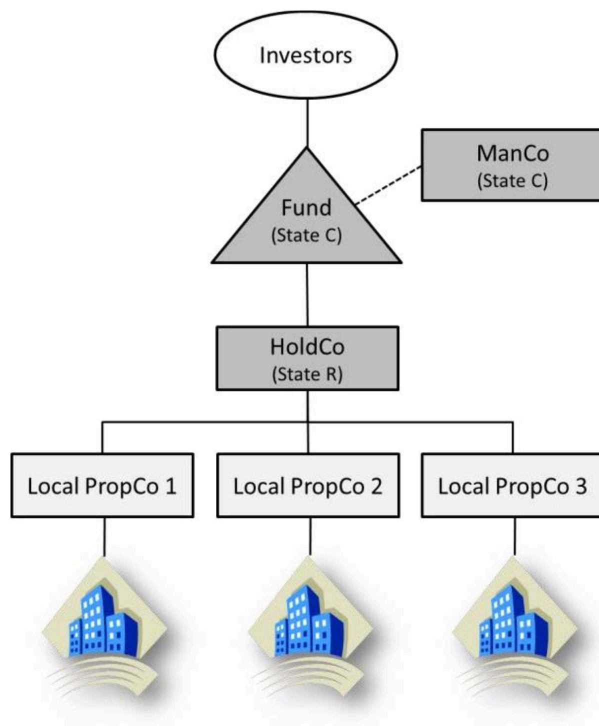
As in the previous example, it is explicitly stated that the very fact that RCo considers the existence of a benefit under the State R–State S tax treaty with regard to interest payments would not be sufficient to trigger the application of the PPT. The guidance re-emphasizes that the intent of tax treaties is to provide benefits to encourage cross-border investment. Therefore, it is necessary to consider the context in which the investment was made. As regards the SV example, it is concluded that it would not be reasonable to deny the benefit of the State R–State S tax treaty unless other facts and circumstances suggest otherwise.

A Real Estate Fund

Example M deals with a real estate fund (the "Fund") that is established in State C for investing into a portfolio of real properties situated in a specific geographic area. According to the fact pattern, the Fund is fiscally transparent under the domestic tax law of State C and managed by a regulated fund manager. The Fund is marketed to institutional investors such as pension funds and sovereign wealth funds. Commitments to the Fund have been made by a range of investors resident in different jurisdictions.

The investment strategy of the Fund which is set out in the marketing materials for the Fund is not driven by the tax positions of the investors but is based on investing in certain real estate assets, maximizing their value and realizing appreciation through the disposal of the investments.

The investments of the Fund are structured via a holding company that is resident in State R ("HoldCo"). HoldCo manages all investments of the Fund in immovable property assets and holds these assets indirectly through wholly-owned local companies. HoldCo further provides debt and equity to these local companies which directly own the real properties.



HoldCo is established for a number of commercial and legal reasons, such as:

- protection of the Fund from the liabilities of and potential claims against the Fund's immovable property assets;
- facilitation of debt funding (including debt obtained from third parties);
- management of investments (including the acquisition and disposal thereof);
- administration of claims for relief of withholding tax under any applicable tax treaty (according to the guidance in the example, this is an important function of HoldCo as it is administratively simpler for one company to get treaty relief rather than to have each institutional investor process its own claim for withholding tax relief. This holds all the more true when each investor would be entitled to treaty benefits on a small amount).

Following a review of possible locations, the decision to establish HoldCo in State R was mainly driven by:

- the political stability in the holding jurisdiction;
- the regulatory and legal systems of the holding jurisdiction;
- lender and investor familiarity with the holding jurisdiction;
- access to appropriately qualified personnel; and
- the extensive tax treaty network of State R, including tax treaties with the different target jurisdictions.

It is further stated that HoldCo does not obtain treaty benefits that are better than the benefits to which its investors would have been entitled if they had made the same investments directly (under the tax treaties concluded between the investor and investment jurisdiction to the extent applicable).

In the example, it is explicitly mentioned that the immovable property investments of the Fund are made for commercial purposes despite the decision to establish HoldCo in State R having been taken against the backdrop of the tax treaty network of State R and related tax treaty benefits. In addition, given that it was assumed that the investors would be entitled to the same treaty benefits in case of direct investments, no additional benefit has been generated through the structuring of investments via HoldCo. As regards this example, it is concluded that it would not be reasonable to deny tax treaty benefits unless other facts and circumstances suggest otherwise.

Reasons for Establishing a Company in Luxembourg

Opening comments

When analyzing the potential application of the PPT in case of Luxembourg companies it is necessary to consider (i) the reasons for choosing Luxembourg as a business location, (ii) the substance and corporate governance of the company, as well as (iii) its functional and risk profile, and (iv) the commercial and legal reasons for establishing the company.

Features of the Location

The three examples mention a number of different reasons that might be considered when deciding on the optimal jurisdiction for establishing a company. These reasons include:

- the political stability of the jurisdictions;
- the regulatory and legal environment;
- lender and Investor familiarity with the jurisdiction;

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- the availability of directors with knowledge of regional business practices and regulations;
- the existence of a qualified, multilingual workforce; and
- the membership of the holding jurisdiction to a regional grouping (for example, the EU).

Depending on the investment activity, more specific considerations, such as the existence of a robust securitization framework and other relevant legislation, might be a key reason when deciding on the residence state of a company. Furthermore, it has been explicitly stated that an extensive tax treaty network including tax treaties with the investor and the investment jurisdictions is a positive feature of a jurisdiction.

Luxembourg is a prominent financial center with a major fund industry and a tried and tested holding location that meets all the above criteria. In addition, Luxembourg has a flexible and diverse regulatory framework which provides for a number of different (fund) vehicles and regimes that can be tailored to the needs of each individual set-up. Easy access to the authorities (including the regulatory bodies) further contributes to the investor-friendly business environment in Luxembourg.

When investors consider a potential future IPO or the issuance of bonds (or other financial instruments) to the public, Luxembourg has a recognized stock exchange that provides access to the capital markets. Last but not least, the healthy budgetary and financial situation of Luxembourg cannot be overrated as an element that maintains the trust of investors against the backdrop of events witnessed in other countries.

Substance and Corporate Governance

Substance is a key element in international tax planning and is relevant for the application of both domestic tax law and tax treaties. The notion of substance involves a number of elements such as:

- equipment, facilities and employees;
- directorship and the place where decisions are taken;
- legal documentation and contractual aspects;
- transfer pricing documentation;
- the actual conduct of business activities; and
- business purpose.

Substance is crucial for managing tax residency and to avoid a situation in which a corporate structure is (partially) disregarded under foreign anti-abuse provisions. The notion of substance also concerns the beneficial ownership concept that is employed under tax treaties and in some cases under domestic tax law with the objective to avoid tax treaty or EU directive shopping. When Luxembourg companies operate in foreign jurisdictions, it is crucial to avoid the constitution of unintentional permanent establishments that could otherwise give rise to significant tax costs in the respective host states. Appropriate substance is further relevant in order to avoid the application of the PPT in tax treaties.

In light of the above, it is 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 substantially all appointed directors.

The board of directors should be composed at least in part, if not in majority, 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. Example K, described above, cites a board composed of majority of local resident directors—such a board composition is a common recommendation in substance related discussions. Examples L and M, however, are silent on the subject of the board composition. Thus, nonresidents may be part of the board, or, as external advisers, may make strategic recommendations to the board: however, the directors must independently appraise each proposal and not merely "rubber stamp" the recommendations. The meetings of the board of directors should be properly documented in the minutes of these meetings that should at least include a description of the topics discussed and the decisions taken.

A Luxembourg company should further have a Luxembourg bank account and its books and records should be kept in Luxembourg. The equipping of a Luxembourg company with facilities (i.e., a dedicated and equipped office space) and (part-time) employees should be appropriate for the business activities performed and needs to be determined on a case-by-case basis.

In practice, there are different ways to organize the substance of a Luxembourg company, ranging from set-ups with significant internal resources that manage most of the tasks internally, to set-ups that rely, for cost-efficiency purposes, on an outsourcing model where certain functions are outsourced to qualified service providers (or other group companies) and monitored by the employees or the directors of the company (for example, accounting and compliance services).

In other cases, asset managers may have significant substance in a management or service company that renders services to other Luxembourg companies. While the charging of services to the Luxembourg beneficiaries may be a good indication of the activities performed by these entities, the tax authorities of some investment jurisdictions have a strong preference to find salary costs in the financial statements of entities that rely on benefits under their domestic tax law or tax treaties. Here, global employment contracts that split the salary costs of employees between the different group companies benefiting from their work may provide a better comfort level. In addition, other costs such as rental costs may be split among different Luxembourg companies in accordance with appropriate allocation keys.

Functional and Risk Profile

Another aspect to be considered is the functional and risk profile of the company, which may vary from one case to another. The examples in the Commentary already provide for a number of functions that might be performed by a holding company, including:

- approving and monitoring investments;
- carrying on treasury functions;

- maintaining the books and records of the company; and
- ensuring compliance with regulatory requirements in the investment jurisdictions.

In practice, Luxembourg companies may perform a number of additional functions, such as:

monitoring of the performance of subsidiaries;

- analyzing investment opportunities;
- rendering of administrative and other services to subsidiaries;
- monitoring of dividend, interest and other payments;
- performing financial controlling within the group (optimization of the group's interest costs, etc.)
- monitoring and management of risks in relation to the investment activities;
- management of intangible property rights;
- drafting or review of legal documentation;
- preparation of financial reporting;
- dealing with accounting and bookkeeping requirements;
- direct and indirect tax compliance.

Luxembourg companies that perform holding and financing activities generally have an even more diverse functional and risk profile. Under the Luxembourg transfer pricing rules, companies performing financing activities are required to have a real presence in Luxembourg, to determine the equity at risk in relation to the loan portfolio and to report an arm's length remuneration on their financing activities in conformity with the OECD Transfer Pricing Guidelines.

When certain functions are outsourced to qualified Luxembourg service providers or other group companies, it is for the directors or staff of the Luxembourg company to carefully monitor the proper performance of these functions.

Commercial and Legal Reasons

Investors generally have a number of legitimate commercial and legal reasons for the implementation of a company in Luxembourg. Reasons mentioned in the examples include:

- protection of the Fund from the liabilities of and potential claims against the Fund's immovable property assets;
- facilitation of debt funding (including debt obtained from third parties);
- management of investments (including the acquisition and disposal thereof); and
- administration of claims for relief of withholding tax under any applicable tax treaty.

However, there may be many other commercial and legal reasons such as:

- existing operations and "substance" in Luxembourg for the management of other investments, generating synergies and cost-efficiencies over all the investment structures;
- flexibility of the Luxembourg regulatory environment (freedom in terms of structuring, time to market, etc.);
- existing business relationships with Luxembourg business partners and service providers;
- benefits derived from the EU passporting system under the European AIFMD (the prudential directive dealing with alternative fund management);
- familiarity of investors with the legal and regulatory environment allowing fund distribution to an international investor base;
- experience of the Luxembourg marketplace regarding the structuring and management of alternative investments.

Considerations Regarding Alternative Investments Structured via Luxembourg

Application of the PPT in General

According to OECD guidance, the PPT requires an in-depth analysis of all facts and circumstances of each case in order to determine whether obtaining the benefit was a principal consideration and would have justified entering into an arrangement or a transaction that has resulted in the benefit. Thus, tax authorities should not easily conclude that (one of) the principal purpose(s) was to obtain benefits under a tax treaty.

When it comes to the interpretation of the examples in the Commentary, it is explicitly stated that the examples are "purely illustrative" and should not be interpreted as providing conditions or requirements that similar transactions must meet in order to avoid the application of the PPT. Therefore, it cannot be construed that the PPT should apply if a particular aspect described in the examples is missing. Instead, it has to be determined on a case-by-case basis whether one of the principal purposes of an arrangement or a transaction was obtaining treaty benefits.

In practice, the reasons and factual circumstances that are relevant for the decision to structure investments via Luxembourg companies may vary significantly from one case to another (existing operations, functions, commercial and regulatory reasons, etc.). Given these differences, taxpayers should establish the reasoning of their decision to structure investments via Luxembourg so as to be prepared for potential questions from foreign tax authorities.

The examples in the Commentary further seem to hint at certain factors, that when present, reduce the risk of the PPT being applied, such as:

- investors are resident in different jurisdictions;
- investments are made in different target jurisdictions;
- an investment structure is subject to regulation.

However, even if investors are resident and investments are made predominantly in one jurisdiction, the examples do not seem to suggest that the PPT should be applicable in any case. Rather, an analysis of all facts and circumstances of the specific case should provide answers to the question as to whether one of the principal purposes was to obtain a tax benefit. For example, it might be planned to start with certain investors and to widen the scope of the investor base or the investment jurisdictions at a later stage. Notably, in the examples K and M, investments have been structured by funds via a wholly-owned subsidiary resident in another jurisdiction. In both cases, the Commentary concludes that the PPT should not be applicable.

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The structuring of investments via a Luxembourg fund and Luxembourg companies should make corporate structures even more robust, reinforcing the commercial rationale behind the investment structure. These considerations will likely strengthen the existing trend towards more onshore alternative funds for which Luxembourg's fund industry is well known and equipped.

Whether or not a tax benefit is derived through the structuring of investments via a holding company can clearly be a secondary, rather than a principal purpose, as example K describes a situation in which the tax treaty concluded between the fund location and the investment location was less beneficial than the tax treaty concluded between the holding location and the investment location.

The PPT in an EU Context

In an EU context, the application of the PPT should be subject to a stricter standard, which is determined by the jurisprudence of the CJEU. As a rule, the fundamental EU freedoms of establishment and free movement of capital, as interpreted by EU case law, provide that a given structure may only be disregarded if it is proven to be a "wholly artificial arrangement" which does not reflect economic reality and the purpose of which is to unduly obtain a tax advantage. Such a purely artificial structure may be present in case of "letterbox companies". In the *Cadbury Schweppes* case, the CJEU acknowledged that a taxpayer is free to rely on its EU freedoms for tax planning purposes as long as the underlying contractual arrangements are not "purely artificial".

The right of a EU Member State to protect its tax base against abusive arrangements is limited by the fundamental freedoms. It follows that "tax jurisdiction shopping" is a legitimate activity in an internal market, even if the choice of jurisdiction is principally based on tax considerations. Why should an investor be obliged to choose a high-tax jurisdiction or arrange his affairs in such a way as to be liable to more tax than necessary? Nevertheless, EU Member States are free to protect their tax bases by way of anti-abuse rules which are exclusively directed at "wholly artificial arrangements".

An abusive situation does not depend only on the intention of the taxpayer to obtain tax advantages (i.e., a motive test) but requires the existence (or absence) of certain objective factors. Among these objective elements, the CJEU emphasized the importance of the existence of an "actual establishment" in the host state (for example, premises, staff, facilities and equipment) and a "genuine economic activity" performed by the foreign company. Here, a company may even rely on staff and premises of affiliated companies resident in the same jurisdiction. Thus, in a fund context, it should suffice if an asset manager has a management company with substance that renders services to all the investment vehicles rather than requiring each and every company in a fund structure to employ staff. This has been a key point of debate to date, with certain source jurisdictions, notably Germany, having legislation (described below and now largely discredited) that pushed fund managers to arrange their operations in such a way as to have "substance" in many individual companies, an outcome that (very ironically), many fund managers felt was fairly artificial.

The notion of "genuine economic activity" should be understood in a very broad manner and may include the mere exploitation of assets such as shareholdings, receivables and intangibles for the purpose of deriving what is often described as "passive" income. The nature of the activity should not be compromised if such passive income is principally sourced outside the host state of the entity.

In addition, no specific ties or connections between the economic activity assigned to the foreign entity and the territory of the host state of that entity can be required by domestic anti-abuse provisions. Therefore, insofar as the EU internal market is concerned, the mere fact that an intermediary company is "active" in conducting the functions and assets allocated to it (rather than being a mere letterbox company) should suffice to be out of the scope of domestic anti-abuse rules or the PPT in tax treaties concluded between EU Member States.

It is interesting to note that until now, national courts have not deviated from the "wholly artificial arrangement" doctrine laid down by the CJEU. While the CJEU does not seem to require an extensive level of substance, from a risk management perspective it may nevertheless be wise to exceed the minimum standard of substance in order to limit foreign tax risks.

As such, the PPT poses significant compatibility issues with EU law. In fact, the PPT may deny treaty benefits on the sole grounds that one of the main purposes was to obtain treaty benefits. Accordingly, even companies having economic substance in their state of residence and performing bona fide business activities may not be entitled to treaty benefits. However, within the EU, restrictions can only be justified by the need to prevent tax avoidance when a specific anti-avoidance rule targets "wholly artificial arrangements" aimed solely at escaping national tax normally due. Considering that the PPT imposes a lower "abuse" threshold than the standard set by the CJEU, serious doubts can be raised on the compatibility of the PPT with EU law.

This concern has been confirmed by a more recent case of the CJEU that may be helpful when analyzing the potential scope of the PPT in an EU context. On September 7, 2017, the CJEU issued its decision in the French case C-6/16 regarding the application of a (former) French anti-abuse provision that automatically denied the withholding tax exemption on dividends under the EU Parent-Subsidiary Directive when dividends were paid to an EU parent company that was controlled by one or more entities established in non-EU countries. Under this provision, the recipient of the dividends only qualified for the exemption if it could prove that benefiting from the exemption was not the main purpose or one of the main purposes of the structure. Accordingly, this provision has been broadly designed as the PPT in the OECD Model.

In the case under review, a French company paid a dividend to a Luxembourg holding company which was indirectly held by a Swiss parent company. According to the French tax authorities, the Luxembourg company was not able to demonstrate that the main purpose or one of the main purposes for estab-

lishing the structure was not to benefit from the withholding tax exemption. The French court finally asked whether this rejection was in accordance with EU law and referred the case to the CJEU.

The CJEU ruled that the French anti-abuse provision infringed both the EU Parent-Subsidiary Directive and the freedom of establishment as it only took into account the taxpayer's motive for the structure. It did not, however, make an individual examination of the whole operation and it did not contain an "economic activity" (or "substance") test as required under EU law. In addition, the burden of proof automatically rested with the taxpayer, whereas the French tax authorities did not even have to evidence tax avoidance when denying the dividend withholding tax exemption.

German tax law also provides for an anti-abuse provision that denies withholding tax exemptions (or reductions) granted under domestic tax law or tax treaties unless the recipient of the income complies with certain (excessive) substance requirements. On December 20, 2017, the CJEU gave its decision in two German cases (Cases C-504/16 and C-613/16) that have been referred by the *Finanzgericht Köln* (Finance Court Cologne) and which were joined for the purposes of the judgment.

In the first case, a German company paid a dividend to a Dutch holding company which was a wholly-owned subsidiary of a German resident individual. In the second case, a German company paid a dividend to a Danish holding company that was owned by an individual resident in Singapore. In both cases, the German tax authorities refused a refund of withholding tax levied on these distributions.

In line with its decision in the French case, the CJEU ruled that the German anti-abuse provision infringed both the EU Parent-Subsidiary Directive and the freedom of establishment, re-emphasizing its "wholly artificial arrangement" standard. Indeed, a general presumption of fraud or abuse cannot justify either a fiscal measure which compromises the objectives of the Parent-Subsidiary Directive or a fiscal measure which prejudices the enjoyment of the fundamental freedoms guaranteed by the treaty.

When assessing the existence of fraud and abuse, tax authorities may not rely on predetermined general criteria as set out in the German anti-abuse provision. Instead, tax authorities have to carry out an individual examination of the whole operation at issue. The imposition of a general tax measure automatically excluding certain categories of taxable person from the tax advantage, without the tax authorities being required to provide even *prima facie* evidence of fraud and abuse, goes beyond what is necessary to prevent fraud and abuse. Moreover, when applicable, the German anti-abuse provision establishes an irrebuttable presumption of fraud or abuse.

The aforementioned decisions of the CJEU are a testimony to its "wholly artificial arrangement" standard and should have a significant impact on the interpretation of anti-abuse provisions in an EU context. The CJEU made clear that neither a mere motive test nor excessive substance requirements are in conformity with EU law.

Going Forward

Luxembourg is a prime location for the structuring of alternative investments in and through Europe. Therefore, the question as to whether Luxembourg companies involved in these investment structures may benefit from tax treaties concluded by Luxembourg is of utmost importance. While it would have been preferable to explicitly exclude non-CIV funds and their subsidiaries from the scope of the PPT, the guidance provided in the Commentary to the OECD Model seems to significantly limit the scope of application of the PPT in case of these bona fide investment activities.

There remains, however, some uncertainty as to when foreign tax authorities may deny tax treaty benefits. Given the current diverging attitudes of foreign tax authorities in regard to the application of anti-abuse provisions, it might be expected that the PPT will also be interpreted differently by different tax authorities. Therefore, it would be wise for taxpayers to establish the reasoning of their choice to invest via a Luxembourg company or fund so as to be prepared for potential questions from foreign tax authorities.

In an EU context, the jurisprudence of the CJEU is particularly helpful for the interpretation of anti-abuse provisions such as the PPT. Apart from established CJEU case law, the more recent decisions on French and German anti-abuse rules confirm the Court's adherence to its longstanding "wholly artificial arrangement" tenet which puts strict limitations to the scope of anti-abuse legislation. Both decisions should have a major impact on EU lawmakers and tax authorities alike, paving the way for greater legal certainty in cross-border investment structures.

Oliver R. Hoor is a Tax Partner (Head of Transfer Pricing and the German Desk) and Keith O'Donnell is the Managing Partner of ATOZ Tax Advisers (Taxand Luxembourg).

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The authors may be contacted at:oliver.hoor@atoz.lu; keith.odonnell@atoz.lu

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