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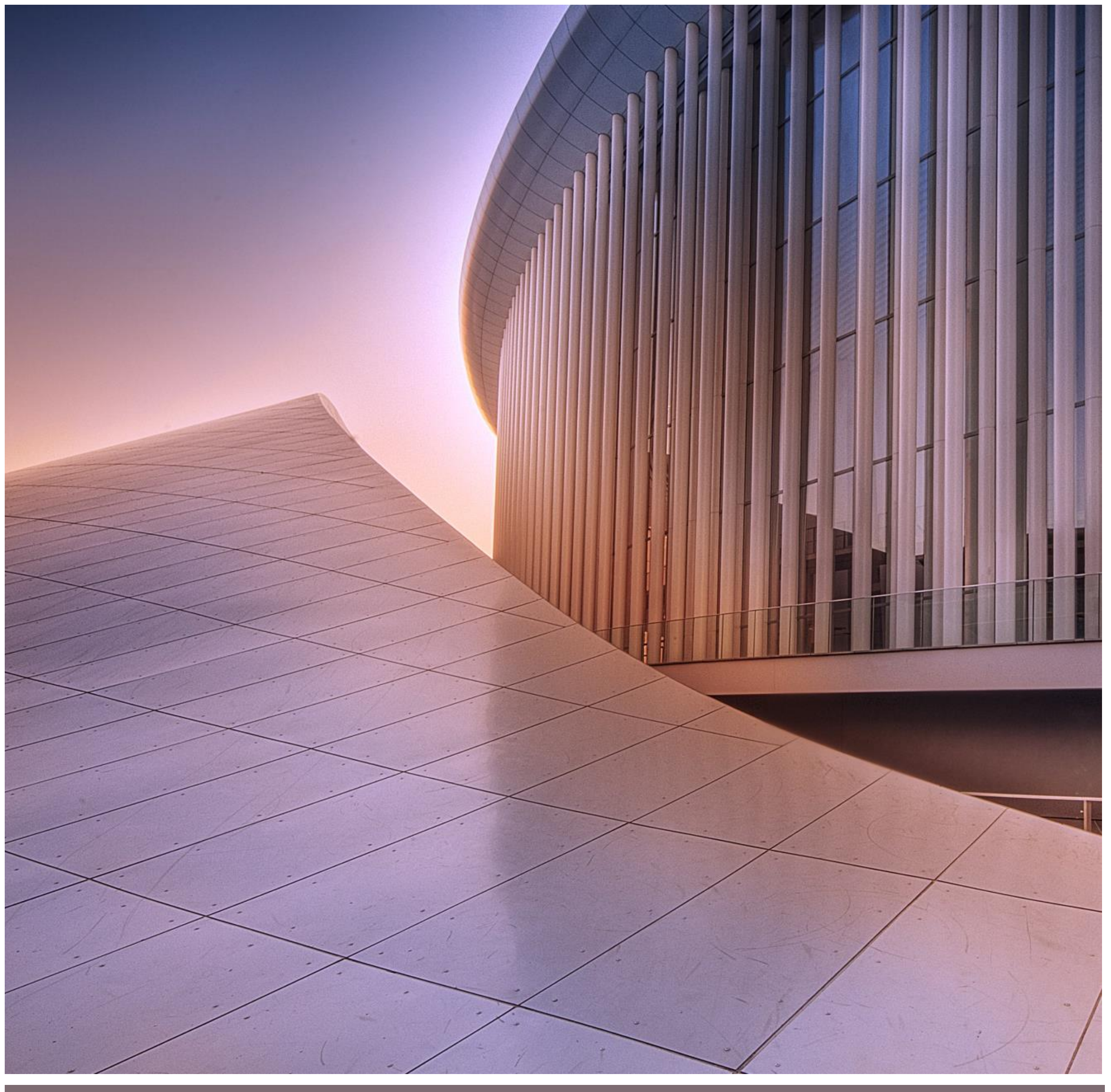

BONN STEICHEN & PARTNERS

NEWSLETTER

DATED

APRIL 2018

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AML

IMPLEMENTATION OF THE 4TH ANTI-MONEY LAUNDERING DIRECTIVE

The law of February 13th 2018 ("**AMLD Law**") which entered into force on February 18th 2018 has now implemented most of the outstanding provisions of the 4th Anti-Money Laundering Directive ("**4th AML Directive**") into Luxembourg Law. This law introduces amendments to the Luxembourg Law of November 12th 2004 on the fight against money laundering and terrorist financing. The law will have immediate effect without a transitional period. In addition to implementing the provisions of the 4th AML Directive, certain additional recommendations of the Financial Action Task Force have also been included.

Key definitions are now provided and/or extended. The definition of "beneficial owner" for corporate entities has been extended so as to include situations where it is not possible to identify a beneficial owner as per 2004 Law criteria; in such case the natural persons who hold the position of senior manager are to be considered as the beneficial owner. In relation to trusts, the AMLD Law now requires all parties to a trust be identified. The definition of "Politically exposed persons" has been extended to include members and directors of the board of an international organisation and also brothers and sisters in the definition of 'family members'.

The 4th AMLD Law also creates new obligations in relation to internal procedures. Professionals must ensure that they follow an appropriate risk management procedure as well as risk assessment systems.

In relation to due diligence, there is a simplified requirement if the transaction meets the criteria of Annex II of the 4th AML Directive. In contrast, there is an enhanced due diligence requirement with regard to relationships which have a high AML/CTF risk, such as business relationships with a person in a third country.

The 2004 Law now also has wider scope, adding gambling services (including internet gambling) in the category of professionals subject to the law.

It is necessary to implement training programmes for employees in order to ensure they can identify indications of money laundering and also whistleblowing measures must be provided for staff.

Furthermore, professionals must inform clients about their data protection rights and keep detailed records. In some specific cases, the competent authorities may demand to retain information and documents for an additional five-year period (compared to the initial five-year period).

The Financial Intelligence Unit and the various supervisory authorities shall closely cooperate and are authorised to exchange information.

Finally, administrative penalties are relatively increased through the reinforcement of the sanctioning powers of the financial authorities. The *Commission de surveillance du Secteur Financier* (CSSF), the *Commissariat aux Assurances* (CAA) and the *Administration de l'enregistrement et des domains* (AED) are now specifically listed as supervisory authorities. Sanctions which can no longer be challenged before court shall be published on their website. In addition, criminal fines have been increased from a range of €1,250-€1,250,000 up to €12,500-€5,000,000.

BANKING & FINANCE

MIFID II & MIFIR | UPDATE OF ESMA Q&A

On March 23rd 2018, the European Securities and Markets Authority ("**ESMA**") updated a number of its Q&A regarding the Markets in Financial Instruments Directive (recast) – Directive 2014/65/EU ("**MiFID II**") and Markets in Financial Instruments Regulation – Regulation 600/2014 ("**MiFIR**"), specifically:

- Q&A on investor protection and intermediaries topics;
- Q&A on transparency topics;
- Q&A on commodity derivatives topics; and
- Q&A on markets structures topics.

We will focus here on just a few of the updates to the Q&A on investor protection and intermediaries topics (hereafter, the "**Q&A**").

With respect to inducements, ESMA has confirmed how investment firms providing the investment service of portfolio management should treat inducements received after January 3rd 2018 with regards to financial instruments in which the firm has invested on behalf of the client before that date. In short, ESMA has confirmed that only ongoing inducements accrued until January 2nd 2018 can be received (subject to compliance with the requirements of Directive 2004/39/EC on markets in financial instruments ("**MiFID I**").

On the topic of research related inducements, ESMA has provided some clarification (i) on whether macro-economic analysis can be considered research that can be paid for from a research payment account and client research charges under Article 13(1)(b) of the Commission Delegated Directive (EU) 2017/593 supplementing MiFID II (the "**MiFID II Delegated Directive**") and (ii) on how research related to fixed income, currencies or commodities should be treated for the purposes of the MiFID II inducements restriction for firms providing portfolio management or independent investment advice.

With respect to additional reporting obligations for portfolio management described in Article 62(1) of the Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU (the "**MiFID II Delegated Regulation**"), ESMA has confirmed that the investment firm is not required to report to the client each time the overall value of the portfolio exceeds a threshold if no new threshold is exceeded. With respect to the additional reporting obligations in Article 62(2) of the MiFID II Delegated Regulation on particular investment firms (i.e. those that hold a retail client account that includes positions in leveraged financial instruments or contingent liability transactions) to inform the client where the initial value of each instrument depreciates/multiplies, the meaning of the phrase "*hold a retail client account*" has been clarified. ESMA confirms it could be understood as providing the ancillary service of safekeeping and administration of financial instruments for the account of retail clients or holding an account intended for registering clients transactions on financial instruments (in the context of an investment service rendered to a retail client).

Finally, ESMA has clarified the interpretation of the term "*ongoing relationship*" within the MiFID II Directive and the MiFID II Delegated Regulation, noting that it should be understood to have its ordinary meaning, should be interpreted consistently across the legislation and should apply to client relationships that are continuing or have been so during the preceding year.

CAPITAL MARKETS

PROSPECTUSES | UPDATE OF ESMA Q&A

On March 28th 2018 the European Securities and Markets Authority ("**ESMA**") updated its Questions and Answers on Prospectuses ("**Q&A**") to include one new question and answer on profit forecasts, specifically how it can be determined whether a profit forecast has been made.

ESMA firstly reiterates the definition of a profit forecast contained in Article 2(10) of the Prospectus Regulation EU 809/2004 (the "**Original Prospectus Regulation**"): "*a form of words which expressly states or by implication indicates a figure or a minimum or maximum figure for the likely level of profits or losses for the current financial period and/or financial periods subsequent to that period, or contains data from which a calculation of such a figure for future profits or losses may be made, even if no particular figure is mentioned and the word "profit" is not used.*"

ESMA breaks down the definition with reference to various terms used therein and then provides some practical examples of (i) wording that is considered to be a profit forecast, (ii) accounting data or financial indicators that may, on certain occasions, be considered as constituting a profit forecast and (iii) wording that is not considered to be a profit forecast. ESMA has also clarified that long term financial objectives or forecasts may be considered as profit forecasts depending on facts and circumstances and has pointed out that merely stating that information in a prospectus is not a profit forecast is not sufficient to remove such information from the scope of that definition. Finally, we are reminded by ESMA that profit forecasts and related assumptions must be clearly identified as such in a prospectus.

ESMA notes in its press release regarding the Q&A that although the Prospectus Regulation (EU) 2017/1129 (the "**New Prospectus Regulation**") will become applicable on July 21st 2019, (at which time the Original Prospectus Regulation will be repealed), the definition of a profit forecast should be carried over to the new prospectus regime.

MARKET ABUSE | UPDATE OF ESMA Q&A

On March 23rd 2018 the European Securities and Markets Authority ("**ESMA**") updated its Questions and Answers on the market abuse regulation ("**Q&A**") to amend Question 5.1 on the disclosure of inside information related to Pillar 2 requirements ("**Question 5.1**").

In the context of credit institutions that are subject to both the market abuse regime, established under Regulation (EU) No 596/2014 on market abuse (the "**Market Abuse Regulation**") as well as the prudential supervision of the banking regulators, Question 5.1 queried whether such credit institutions are required to publish systematically the results of the Pillar II assessment. This question has now been extended to cover whether credit institutions are also required under the Market Abuse Regulation to publish any information received in relation to the Minimum Requirement for own funds and Eligible Liabilities ("**MREL**") exercise. The MREL exercise is conducted by the Single Resolution Board in accordance with Directive 2014/59/EU of May 15th 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (the "**Bank Recovery and Resolution Directive**") and is intended to ensure banks have, at all times, enough capital and eligible liabilities to be bailed-in, where necessary.

ESMA has now confirmed that whenever a credit institution which is subject to the Market Abuse Regulation is made aware of information in the context of the MREL exercise, it is expected to evaluate whether that information meets the criteria of inside information. If it does, the relevant disclosure requirements under the Market Abuse Regulation will apply to that credit institution.

INVESTMENT FUNDS

CLARIFICATION OF THE DEPOSITARY REGIME APPLICABLE TO PART II-UCIS

On March 1st 2018, a law was published to modify, *inter alia*, the law of 17 December 2010 on undertakings for collective investment (the "**2010 Law**"). Luxembourg Parliament voted to clarify the depositary regime for funds subject to Part II of the 2010 Law ("**Part II-UCIs"**).

It is worth recalling that the UCITS depositary regime differs from the AIFMD depositary regime in two material ways: (i) the AIFMD depositary regime allows for the contractual transfer of liability from the depositary to the sub-depositary, and (ii) the AIFMD depositary regime allows for the re-pledging of assets.

Although Part II-UCIs always qualify as alternative investment funds as per the law of 12 July 2013 on managers of alternative investment funds (the "**2013 Law**"), the revised 2010 Law now distinguishes the following cases:

- Part II-UCIs that permit marketing to retail investors in Luxembourg in their offering documents.
  For these funds, the depositary regime provided for in Part I of the 2010 Law will apply.
- Part II-UCIs that exclude the marketing to retail investors in Luxembourg in their offering documents and are managed by an authorised AIFM.
  For these funds, the AIFMD depositary regime (rather than the UCITS depositary regime) will apply.
- Part II-UCIs that exclude the marketing to retail investors in Luxembourg in their offering documents and are managed by a registered AIFM or a non-EU AIFM.
  The depositary regime provided for in the law of 13 February 2007 on specialised investment funds will apply.
  This clarification of the depositary regime will be particularly helpful in situations where a Part II-UCI uses a sub-depositary (e.g. prime broker), and where the depositary does not want to be liable for the loss incurred by such sub-depositary.

EU LEGISLATIVE PROPOSALS TO FACILITATE THE CROSS-BORDER DISTRIBUTION OF INVESTMENT FUNDS

On March 12th 2018, in the context of the Capital Markets Union action plan, the European Commission issued legislative proposals to amend the existing legal framework for the cross-border distribution of investment funds in the EU. These proposals contain a directive and a regulation (the "**Proposals**"). The purpose of the Proposals is to reduce regulatory barriers to the cross-border distribution of investment funds in the EU. These new measures are expected to reduce the cost for fund managers of going cross-border and should support more cross-border marketing of investment funds notably by reducing regulatory barriers, including those pertaining to marketing requirements, regulatory fees and notification requirements. The new directive aims at amending both the UCITS and AIFM directives with regard to the cross-border distribution of collective investment funds. The new regulation aims at facilitating cross-border distribution of collective investment funds and amending the European venture capital funds ("**EuVECA**") regulation and the European social entrepreneurship funds' ("**EuSEF**") regulation.

The Proposals would introduce the following amendments:

- A legal definition of "pre-marketing" will be introduced for alternative investment funds, EuVECA and EuSEF and would lay down the conditions under which an EU alternative investment fund manager may engage in pre-marketing activities. The Proposals will introduce more transparency as to the marketing requirements at national and EU level.
- To foster transparency, the fees and charges as well as the calculation methodologies applied by national competent authorities will have to be made public by these regulators (already the case in most but not all of the EU jurisdictions).
- No physical presence would be required in Member States where funds are marketed since the Proposals only refer to the provision of facilities to UCITS investors and retail investors investing in AIFs for the processing of their subscription and redemption orders as well as payments. Investors would have access to offering documents and annual reports in a durable medium and in the relevant jurisdiction's official language.
- Harmonisation of the procedures and requirements for updating notifications of the use of the marketing passport (or for de-registrations as the case may be) are suggested to be introduced both for UCITS and AIFs.
- Establishment of a process in order to enable AIFs and UCITS fund managers to discontinue marketing activities once such activities have become insignificant in a specific jurisdiction.

The EU Parliament and the Council of the EU are now asked to review the legislative Proposals.

THE BENCHMARKS REGULATION

The Luxembourg Law of April 17th 2018 on indices used as benchmarks ("**Luxembourg Benchmark Law**") was adopted in order to implement Regulation (EU) No. 2016/1011 of 8 June 2016 on indices used as benchmarks ("**Benchmarks Regulation**" or "**BMR**"), which came into effect on January 1st 2018. This Luxembourg Benchmark Law designates the *Commission de Surveillance du Secteur Financier* ("**CSSF**") or, in certain cases the *Commissariat aux Assurances*, as the competent authority to enforce the provisions of the Benchmark Regulation and ensure compliance therewith. The Luxembourg Benchmark Law followed an earlier press release by the CSSF dated October 30th 2017 in which the CSSF highlighted the salient provisions of the Benchmark Regulation.

The CSSF first addressed scope of the new EU directive, noting that the Benchmark regulation targets three (3) main actors:

1. Benchmark administrators;
2. Contributors of input data to benchmarks; and
3. Regulated entities that use indices as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds.

The CSSF then highlighted a number of specific provisions applicable to supervised entities.

Pursuant to Article 29, paragraph 1 of the BMR, a supervised entity (defined in Article 3, paragraph 1, point 17) may use a benchmark or a combination of benchmarks if the benchmark is provided by an administrator located in the Union and included in the register established and managed by ESMA referenced in Article 36 of the BMR (the "**Register**"), or any benchmark listed therein.

Listing on the Register is restricted to:

(i) A natural or legal person located in the Union that intends on acting as administrator and having received approval or registration to that effect as per Article 34 of the BMR; and

(ii) A benchmark or a combination of benchmarks provided by an administrator located in a third country as well as the administrator in question, if:

   a. an equivalence decision has been adopted by the Commission in accordance with Article 30 of the BMR;
   b. the administrator in question has acquired prior recognition by the competent authority of its Member State of reference in accordance with Article 32 of the BMR; or
   c. The benchmark or combination of benchmarks in question has been given consent as per Article 33 of the BMR.

In an effort to prevent market disruption, the Benchmarks Regulation provides for, in certain specific situations (see Article 51), a transitional regime of two years starting on the date the Benchmarks Regulation came into effect.

As per Article 29, paragraph 2 of the BMR, where the object of a prospectus to be published under Directive 2003/71/EC or Directive 2009/65/EC is transferable securities or other investment products that reference a benchmark, the issuer, offeror, or person asking for admission to trade on a regulated market must ensure that the prospectus also includes clear and prominent information stating whether the benchmark is provided by an administrator included in the Register. Prospectuses of securities must provide this information as of January 1st 2018. For the prospectuses relating to UCITS approved prior to January 1st 2018 and using a benchmark, the underlying documents must be updated at the latest twelve months following this date.

It is also worth recalling that, as per Article 28, paragraph 2 of the BMR, supervised entities that use a benchmark must produce and maintain robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided. The supervised entities must also reflect those plans in the contractual relationship with their clients.

PRIIPS | LAW OF APRIL 17TH 2018

On April 19th, the law of April 17th 2018 on key information documents for packaged retail investment and insurance products (formerly draft Law 7199) (the "**Law**") was published in the Official Journal of Luxembourg. The law implements provisions of Regulation (EU) No. 1286/2014 (the "**Regulation**") and amends the law of December 17th 2010 on UCITS ("**UCITS Law**").

The Law outlines administrative sanctions and measures in relation to non-compliance with the Regulation. It sets out the investigatory powers of the *Commission de Surveillance du Secteur Financier* (CSSF) and the *Commissariat aux Assurances* (CAA) as the competent authorities and fixes the maximum and minimum sanctions and fines which can be imposed under the Regulation.

In compliance with provisions of the Regulation the Law includes an express article allowing SICARs and undertakings for collective investment that are not UCITS, to draw up a key investor information document in compliance with Directive 2009/65/CE and provides that in such case those funds are exempted from the provisions of the Regulation until 31/12/2019. The UCITS Law is amended as a result.

TAX

CASE LAW ON PRIVATE WEALTH MANAGEMENT

The Luxembourg Income Tax Code assesses Luxembourg taxpayers differently, depending upon whether they realise business income or income from private financial wealth management. In case of business income, any capital gain will be taxable, as a matter of principle, contrary to capital gains realized in the course of private wealth management, which are tax-exempt as a general rule. Conversely, capital losses are deductible in case of business income, and may be offset against any other income of the taxpayer, whereas such losses are neither deductible nor offsettable, if they occur in the course of private financial wealth management. Hence, it is important to distinguish the two types of activities. The Luxembourg Income Tax Code provides for an autonomous definition of business income. This means in practice, that financial capital income will be taxed according to the private financial wealth management rules, if the conditions set forth by the Income Tax Code for business income are not met. Setting forth the principle however is easier than applying it in practice. The dividing line particularly poses problems in two areas: real estate activities and management of financial assets. Following constant case-law, real estate income is business income, if the main purpose of the investment is the generating of capital gains, the rental income merely being a means to increase the return of the investment until its sale. Conversely, if the main purpose of the holding of the real estate is the realisation of rental income, the buying and selling of the real estate only being the necessary steps undertaken by the taxpayer in order to generate such income, no business income will be realized by the taxpayer. Absent any specific rules applying to the management of private financial wealth management, practitioners always considered the real estate vs. business income case-law to equally apply to the former. That however led to uncertainties in practice, given the fact that, due to its nature, a financial portfolio typically is subject to a more frequent reshuffling than a real estate portfolio. Hence, the tax position of high net worth individuals often was subject to controversy, if they had entrusted their bank with a mandate to manage their portfolio in a somewhat more dynamic manner than the ordinary person. Could those persons be subject to the business income taxation rules?

This is exactly the situation the Higher Administrative Court (*Cour administrative*) had to deal with in its February 8th 2018 ruling (No. 39.274). It confirmed on that occasion that the case law in real estate matters also applies, by way of analogy, to transactions involving the purchase and sale of financial assets. The Higher Administrative Court, however, further added that the specificities of financial private wealth management should get taken into account, too, so that the analogy would not be total. Hence, just as in the case of real estate management, it is thus necessary to determine whether the management of the financial assets is mainly focused on the realization of regular income (dividends, interest), or if the investment strategy is centred on the realisation of capital gains, the collection of dividends and interests only constituting ancillary income for the taxpayer. However, the Court added that the management of financial assets cannot be fully equated with management of real estate assets. Indeed, according to the Court, it is of the very nature of this type of management that the taxpayer is primarily interested in the total return on his investment, which comprises both the regular income and price fluctuations, rather than its two components separately. As a result, unlike what is the case for real estate assets, a

regular rebalancing of the financial portfolio does not lead to business income for the taxpayer. This means in practice that taxpayers may more frequently than in the case of real estate, buy and sell their financial assets, without becoming subject to the business income tax rules. According to the Court, this would only occur in extreme cases, characterized by a large volume of transactions.

This Higher Administrative Court ruling is spot on in terms of its analysis, since it accurately takes into account structural differences between the management of real estate and financial assets, so as to avoid unduly subjecting private financial wealth management to the business income tax rules. Furthermore, as a result of the way it is written, the Court's decision will clearly become a precedent, in the legal sense, having a value beyond the matter dealt with by the Court. There should be no doubt that all the tax courts will be guided by it going forward, as should the tax authorities, though in the latter case probably with some delay.

CASE LAW ON REDEMPTION OF SHARES

Private equity investments channelled via Luxembourg investment vehicles ("**Luxco**") typically generate tax-exempt income (dividends, capital gains) to the investors and are generally funded by way of debt, for example taking the form of convertible preferred equity certificates ("**CPECs**") or alphabet shares. Alphabet shares usually consist of 10 classes of shares, under which all, or at least almost all of the accounting income realised by the Luxco until their redemption goes to class "J". Following the redemption of class "J", the same occurs with class "I", and so forth in reverse alphabetical order. The reason for this strategy is that a redemption of shares is clearly subject to the capital gain rules as applicable to individuals, if a private investor is selling his or her entire stake in Luxco, and provided Luxco swiftly thereafter reduces its share capital by cancellation of the shares thus acquired. Indeed the capital gain in those circumstances is not taxable, because the transaction is deemed a tax liquidation of Luxco. No dividend withholding tax is due at the level of Luxco, if liquidation proceeds get remitted to the investor, since a liquidation gain follows the tax rules of capital gains at the level of the investor. Although said statute would not explicitly also cover the redemption of alphabet shares, it is common practice to consider the capital gain rules to also be available to the redemption of alphabet shares, on the understanding that this would constitute a partial liquidation of Luxco viewed from the investor's perspective. If so, no dividend withholding tax applies in that case, too, since a partial liquidation is treated from a tax point of view as a full liquidation of Luxco.

However, if a company buys back its own shares, one may hesitate on the tax qualification of the operation. On the one hand, if the buyback is not followed by a cancellation of shares, because the company that bought the shares subsequently sells them to a third party or an existing partner, the transaction will be very close to a sale of the shares from the exiting shareholder to the new shareholder, the sale merely taking place via Luxco. Hence, there exist no good reasons for not applying the capital gains rules. On the other hand, it is also clear that a company, in which 100% of the shares changes hands, will simply have new owners, while a company buying back 100% of its shares no longer has any capital. Therefore, if the company cancels the shares it has repurchased, the operation economically participates in the nature of the share capital reductions. Share capital reductions however attract dividend withholding tax, if the cancellation is funded with distributable reserves, which normally not only is the case in practice, but also a requirement under

law for effectuating the share capital reduction. Hence, some practitioners were somewhat uncomfortable with the redemption of alphabet shares, unless all of the shares held by a given shareholder were repurchased and swiftly thereafter redeemed, in which case the transaction qualifies under statute as a partial liquidation of Luxco. This however poses problems where any given investor typically holds prorata shares in the various alphabet classes, so that, if any given class gets redeemed, even entirely, that investor still holds shares in the remaining classes. In that case, one could argue for the partial liquidation regime not to be applicable, and for a dividend withholding tax to become due. That is exactly what the tax authorities did in a case settled by the Higher Administrative Court in its ruling dated November 2nd 2017 (No. 39.193).

The Higher Administrative Court used this first case in order to immediately set the record straight. After a careful and balanced review of the statute provisions, as well as the fundamental principles underpinning the Income Tax Code, the Court concluded that the Luxembourg tax authorities were wrong in restrictively construing the partial liquidation rules. The Court took the view on that occasion that transfers of shares to the company should never be taxable as dividends, regardless of whether the transfer concerned all or part only of the shareholder's holdings in the company. The Court thus aligned the tax treatment of transfers of shares to the company to the sale of shares to third parties, whether or not the transferor sells all or part of his social rights, whether or not the company reduces its share capital following the buyback. Consequently, no dividend withholding tax should have been levied.

This is a land-mark decision which will put the entire private equity industry at ease with their exit strategies. Two caveats however need to be made. The first is an obvious one, but the Court felt it necessary to state it explicitly in its findings. The (partial) liquidation regime only applies to genuine transactions. Hence, if the repurchase price is overstated, the dividend withholding tax will apply to the portion of the repurchase price which may not be justifiable. The second is an implicit one: the redemption may not be "abusive".

TAX TREATY BETWEEN CYPRUS AND LUXEMBOURG

On March 22nd 2018, Luxembourg Parliament approved the double tax treaty between Luxembourg and Cyprus (hereafter the "**Tax Treaty**"). The Tax Treaty should enter into force on January 1st 2019, provided that the exchange of the instruments of ratification between Luxembourg and Cyprus take place in the course of the year 2018.

Cyprus was the last EU member state with which Luxembourg had no double tax treaty. The Tax Treaty includes BEPS compliant provisions and follows the latest OECD standards. The salient features of the Tax Treaty are listed below:

- The Luxembourg net wealth tax is not included as part of the taxes covered by the Tax Treaty;
- Collective investment vehicles that are liable to tax, even if in practice they are exempted from such taxes upon meeting exemption requirements, will be considered as being tax resident and the beneficial owners of the income they receive for the purposes of the Tax Treaty;
- The dividend withholding tax is nil for dividends paid by a company to another company (other than a partnership) which holds directly at least 10% of the capital of the company. In the other cases, this withholding tax amounts to 5% of the gross amount of dividends paid;

- A real estate rich clause has been included, which provides that the taxation right of capital gains realized on shares of a company deriving more than 50% of their value from immovable property of a contracting state is allocated to said contracting state. Otherwise, the capital gains arising from the disposal of shares is only taxable in the country of residence of the seller;
- Both royalties and interest payments will be exempt from withholding tax;
- In accordance with the ML (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting) signed by both countries, the Tax Treaty includes an entitlement of benefits clause which incorporates the Principle Purpose Test to minimize treaty shopping; and
- A specific article has been added regarding offshore activities. Companies involved in offshore activities (i.e. exploration or exploitation of the seabed or subsoil or their natural resources) will be deemed to carry out their activities through a permanent establishment in the country where these activities are performed, provided said activities exceed a 30 days period. This provision also applies to wages paid for offshore activities and certain capital gains (e.g. capital gains on the disposal of exploration or exploitation rights or capital gains on shares deriving their value or the greater part of their value directly or indirectly from such rights).

NEW TAX TREATY BETWEEN FRANCE AND LUXEMBOURG

On March 20th 2018, a new double tax treaty was signed between Luxembourg and France (hereafter the "**Tax Treaty**"), which includes such details as amended notions of permanent establishment, tax residency referring to effective tax liability and introduces a general anti-abuse provision. As a novelty, the scope is extended to other French oversea territories and will include the "French social contributions" (CSG and CRDS). The Tax Treaty includes BEPS compliant provisions and follows the latest OECD standards. The main aspects of the Tax Treaty are the following:

- The "resident" definition under the Tax Treaty is now in line with the latest OECD model and solely includes persons who are subject to tax. Trustees and fiduciaries that are not the beneficial owner of the income cannot be treated as residents in the sense of the Tax Treaty; it is rather the beneficiary himself that could qualify. With regards to French partnerships, groups of persons and other assimilated entities, they can now also qualify as "resident", provided that (i) their place of effective management is located in France, (ii) they are fully subject to tax and (iii) all their partners are fully taxable in France on their share of the profit of said entity.
- The permanent establishment definition also includes commissionaire arrangements, i.e. situations where a dependent agent, without material modification by the company, habitually plays the principal role in leading to the conclusion of contracts. Said arrangements could now lead to the constitution of a permanent establishment. Additionally, independent agents may now also constitute a PE, in cases where they act exclusively or almost exclusively on behalf of one or more enterprises to which they are closely related.
- A 5% dividend withholding tax is foreseen in cases where a company, who is the

beneficial owner, holds at least 5% of the share capital of the distributing company for a period of at least 365 days prior to the distribution. Dividends paid by exempt distributive real estate investment vehicles, such as French "SPPICAVs" or "SIICs", will be subject to a 15% withholding tax, but only if the shareholder owns, directly or indirectly, less than 10% of the share capital of said vehicles. If the shareholder owns more than 10%, the domestic withholding tax rate would apply.

- With regards to capital gains, not only the capital gains on real estate assets will be taxed in the country where the real estate asset is located, but also the capital gains on shares of companies who derive more than 50% of their value from real estate assets located in that country. As a novelty, said test will look back at the last 365 days prior to the disposal, to assess whether the conditions are met. Another specific measure has also been added for individuals that have been resident in the other contracting state during the previous five years. In this case, the disposal of shares representing a substantial participation (a direct or indirect participation of 25% in the profits, together with related persons) is taxable in the other contracting state.
- For cross border employees, the country of residence will regain taxation right over the employment income that has been earned in the country of employment, once the period spent outside the country of employment (i.e. in the country of residence or in a third country) exceeds 29 days. Additionally, French-resident individuals working in Luxembourg will not benefit from an exemption of French tax on their Luxembourg employment income, but rather benefit from the credit method, for the amount of Luxembourg tax suffered.
- The Tax Treaty includes anti-abuse rules under the form of a principal purpose test, which allows Luxembourg or France to deny treaty benefits. Such denial can take place, if obtaining said benefit was one of the principal purposes of the arrangement or transaction, unless it is demonstrated that granting that benefit was in accordance with the object and purpose of the relevant provisions of the Tax Treaty. France also expressly included the possibility, in the protocol to the Tax Treaty, to apply its domestic anti-abuse rules, irrespective of any contrary provisions in the Tax Treaty.
- Lastly, the protocol to the Tax Treaty provides specific rules regarding undertakings for collective investment (hereafter "UCI"). Despite the fact that they are not treated as resident under the Tax Treaty (due to the lack of taxation), they may nonetheless benefit from the provisions of the Tax Treaty with regards to dividend distributions and interest payments, to the extent that (i) the UCI can be assimilated to an UCI of the other contracting State and that (ii) the beneficiaries of the UCI are residents of one of the contracting States or of a State with which the source State (of the payment) has concluded a treaty regarding the administrative assistance to combat tax fraud and tax evasion.

The entry into force of the Tax Treaty is scheduled for January 1st of the year following the ratification of the Tax Treaty, which might be as soon as January 1st 2019, if the ratification process is completed in both countries before the end of the year.

In conclusion, real estate investments, which typically take place through French SPPICAVs or

SIICs will be the most impacted by the provisions of the Tax Treaty and will likely require swift restructuring, given the fact that the new Tax Treaty might enter into force as early as 2019. Financial institutions and other actors of the Luxembourg financial sector active in France through agents' type of structures should also review their commercial model to avoid falling within the new permanent establishment definition.

NEW IP REGIME INTRODUCED IN LUXEMBOURG TAX LAW

On March 22nd 2018, the Luxembourg Parliament formally approved the new tax regime for intellectual property ("**IP Regime**") whose content remains in line with the measures proposed in the draft law submitted by the Minister of Finance to the Luxembourg Parliament on August 4th 2017 (Please see our newsletter's article dated October 2017 on that topic). The new IP Regime will be applicable as of the fiscal year 2018 and will provide, broadly speaking, for an 80% tax exemption on the eligible net income of qualifying IP rights, which, based on the current aggregate tax rate for Luxembourg City, could lead to an effective tax rate of 5.20% on said income.

NEW EU TRANSPARENCY RULES FOR INTERMEDIARIES AND TAXPAYERS

On March 13th 2018, the European Council reached a political agreement on the extension of the Directive on administrative cooperation (hereafter "**the Proposal**"). In substance, persons that are directly or indirectly involved in setting up of cross border arrangements (hereafter the "**Intermediaries**") will be obliged, as from July 1st 2020 onwards, to disclose every cross-border arrangement as soon as it contains one or more of the indicators listed in the Proposal. It should be noted that the obligation will have a retroactive effect and will cover all the reportable cross-border arrangements that have been implemented after the entry into force of the Proposal (most likely in the coming months).

The aforementioned indicators, so-called "hallmarks", are listed in the Annex of the Proposal. A "hallmark" is defined as a "*characteristic or feature of a cross-border arrangement that presents an indication of a potential risk of tax avoidance*". For some of these hallmarks, the Proposal foresees that the arrangement is only reportable, if additionally to the presence of the hallmark, one of the main reasons of the structure was to obtain a tax advantage (the so-called "main benefit test").

Under certain conditions the Intermediaries will not be subject to the reporting obligation, e.g. because they are non-EU intermediaries. In addition thereto, the Proposal provides for the possibility to exclude from the reporting obligation Intermediaries that are subject to professional secrecy rules (e.g.: lawyers). In those cases, the burden to disclose the arrangement is shifted to the taxpayer himself.

The information collected by the tax administration will then be shared through a central directory with all the other Member States in order to "*enable their authorities to be able to promptly react against harmful tax practices and to close loopholes through enacting legislation.*" Furthermore, the EU legislator expects that those reporting obligation, will have a deterring effect on those promoting aggressive tax planning schemes.

It is debatable to what extent the amendment is in line with EU primary Law. Following the principle of proportionality "*the action of the EU must be limited to what is necessary to achieve the*

objectives of the Treaties". By generally presuming that every arrangement that fulfils one of the criteria is potentially abusive and worth to be reported, one could consider that the Proposal places a disproportionate burden on the Intermediaries/taxpayers. In addition, the very broad scope of what could be considered a "reportable cross-border arrangement" will create significant legal uncertainty.

OECD CONSULTATION ON ABUSE OF CRS CIRCUMVENTION

In a recently published consultation document entitled "*Preventing Abuse of Residence by Investment Schemes to circumvent the CRS*", the Organisation for Economic Co-operation and Development (hereafter "**OECD**") was seeking input on how to reduce the risk of using "*residence by investment*" ("**RBI**") schemes in order to avoid the common reporting standard (hereafter "**CRS**"). A RBI program allows an "*individual to obtain a residence right in exchange for a local investment.*" Even though the OECD recognizes that there might be legitimate reasons for individuals to apply for such a status, it considers that those schemes *"can potentially be exploited to help undermine the CRS due diligence procedures*".

As a reminder, the OECD heavily promoted the exchange of information between tax authorities, which led the EU to adopt a directive in order to enhance the automatic exchange of information between the Member States. This Directive 2014/107/EU has been transposed by Luxembourg on December 24th 2015. In substance, the law obliges financial institutions to determine the tax residency of the account holders and to share relevant information with the tax authorities of their country of residence.

In the framework of RBI schemes, an account holder could use his certificate of residence or other documentary evidence in order to self-certify that he is a tax resident in a certain jurisdiction even though he has no real link to that jurisdiction. This is particularly beneficial if the jurisdiction where he claims to be a tax resident (i) is a jurisdiction that levies no or very low personal income tax, (ii) is a non-participating jurisdiction, in which case the financial institution would not be obliged to exchange information. For instance, a taxpayer resident in a jurisdiction with a high fiscal burden could use the residency certificate obtained by way of a RBI scheme in order to prevent that his real jurisdiction of residence obtains information on his fortune or revenues.

In order to prevent this type of abuse, the OECD acknowledges that it is important (i) to identify which RBI schemes represent a high risk and (ii) to adapt the existing CRS due diligence procedures accordingly. As a consequence, financial institutions will possibly have to enhance their due diligence procedure when they are dealing with individuals claiming to be resident in one of the jurisdictions identified by the OECD.

It remains to be seen to what extent the Luxembourg RBI scheme, as introduced by the law dated 8th March 2017, will be impacted by the future recommendations of the OECD.

OECD ADDITIONAL GUIDELINES ON PROFIT ALLOCATION TO PERMANENT ESTABLISHMENTS

On March 22nd 2018, the Organisation for Economic Cooperation and Development (the "**OECD**") published a report, providing additional guidelines on profit allocation to permanent establishments (the "**Report**"). The Report has been issued in the context of the OECD base

erosion and profit shifting action plan and relates more particularly to action 7 on the prevention of the artificial avoidance of permanent establishment status ("**BEPS Action 7**").

BEPS Action 7 recommended changes to the definition of a permanent establishment in the OECD model tax convention, which notably aimed at tackling permanent establishment avoidance through sales made through commissionaires or dependent agents that do not formally conclude contracts and at adapting the existing exclusions of permanent establishment status to digitalised businesses. As to the profit attribution rules, BEPS Action 7 mandated the OECD to develop additional guidance on how the existing rules should be applied going forward considering the changes to the definition of a permanent establishment.

The guidance contained in the Report responds to this mandate and provides for the general principles on the allocation of profits between the head office and a permanent establishment in the particular circumstances addressed in BEPS Action 7, including examples of commissionaire structures for the sale of goods, online advertising and the procurement of goods.

The Report also covers the profit allocation to the permanent establishment in case of application of the so called anti-fragmentation rule, recommended by BEPS Action 7, which prevents the non-recognition of permanent establishment status for activities that might be viewed in isolation as preparatory or auxiliary in nature but that constitute part of a larger set of business activities conducted in the source country by the enterprise if the combined activities constitute complementary functions that are part of a cohesive business operation.

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