



Substance: A wake up call

ATOZ Briefing

21 February 2018

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The background features a series of interlocking gears of various sizes, drawn with black outlines. A hand is visible at the bottom, with a finger pointing upwards towards the center of the composition. A solid blue rectangular box is positioned in the lower right area, partially overlapping the gears and the hand.

INTRODUCTION

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- **Launch of the OECD BEPS Project** in 2013
- **Release of final reports** in October 2015
- Emphasis on **economic substance** and **transparency**
- Implementation of BEPS measures either **unilaterally** or **multilaterally**
- **Extreme legal uncertainty** over the last years

A hand is visible at the bottom, holding a solid blue rectangular card. The card is positioned in the lower right quadrant of the frame. In the background, there are several black-outlined gears of different sizes. One large gear is in the center, with a smaller one to its left and another to its right. A hand is visible at the bottom, holding the blue card. The overall image has a clean, minimalist aesthetic with a white background.

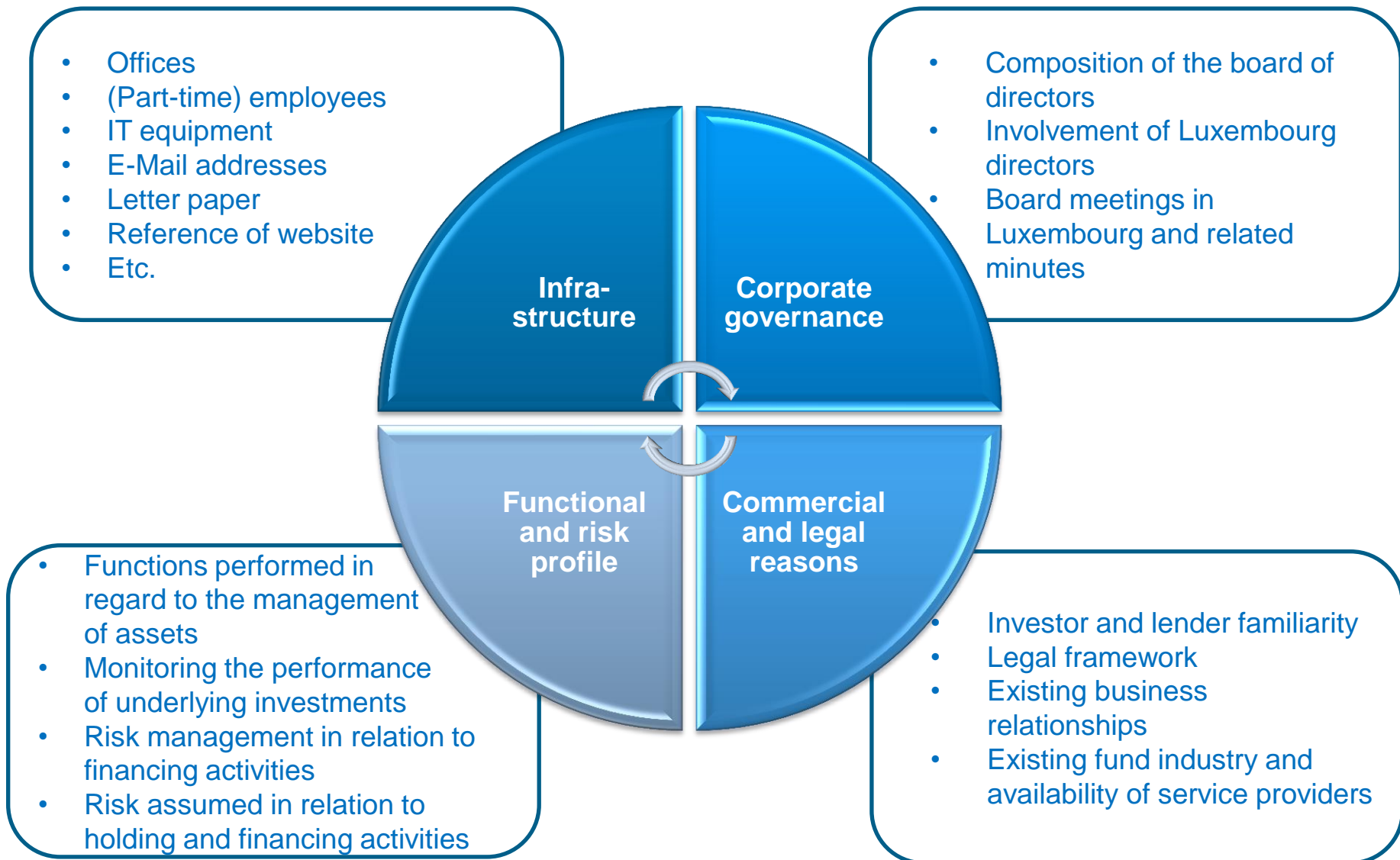
THE NOTION OF SUBSTANCE

THE NOTION OF SUBSTANCE



- **Key element** in international taxation
- Relevant for the application of **domestic tax law, tax treaties** and the **arm's length principle**
- Substance becomes more and more important in order to **safeguard certain tax treatments**
- **Business activities** need to be **structured in a proper manner**
- Since there is a **cost associated to substance**, it is important to analyze what is the **right level of substance** for a given investment structure

THE NOTION OF SUBSTANCE



The background features a series of interlocking gears of various sizes, drawn with simple black outlines. A human hand is visible at the bottom, with a finger pointing upwards towards the center of the composition. A solid blue rectangular box is positioned in the lower right area, containing the title text.

THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX

THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX OVERVIEW



- **Substance requirements** may derive from
 - Luxembourg tax and regulatory law
 - Foreign tax law
 - Tax treaty law
 - A transfer pricing perspective



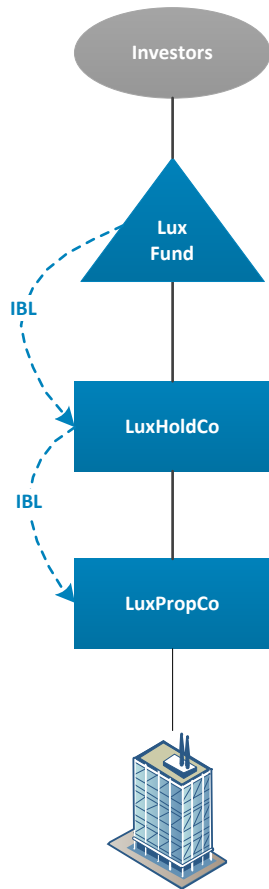
THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A LUXEMBOURG PERSPECTIVE



1. Managing tax residency

- **Place of effective management** or **central administration**
- **Tie-breaker rule** in tax treaties

THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A LUXEMBOURG PERSPECTIVE



2. TP Circular (Financing companies)

- Luxembourg companies performing financing activities come within the scope of the Luxembourg TP Circular
- The TP Circular requires Luxembourg finance companies to have a **real presence in Luxembourg**
- **Qualified minimum substance**

THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A LUXEMBOURG PERSPECTIVE



3. Regulatory requirements

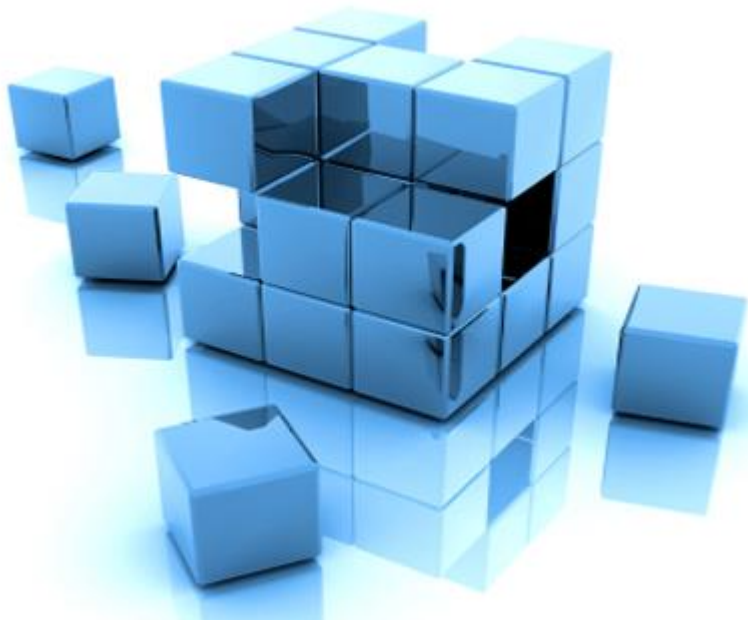
- **Potential models:**

- Set up of a management team in Lux
 - Delegation of portfolio management by a Lux AIFM
 - Advisory model
- 3 board members, at least 2 conducting officers (including two Luxembourg residents)

- **Three core functions:**

- Risk Management
 - Portfolio Management, and
 - Legal & Compliance (L&C)
- If portfolio management is delegated, risk management must be performed internally (and vice versa)

THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A FOREIGN TAX PERSPECTIVE



1. Anti-abuse provisions

- **Anti-Treaty/Directive Shopping**
- **Controlled foreign company (CFC) rules**
- **General anti-abuse rules (GAAR)**

THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A FOREIGN TAX PERSPECTIVE



2. Substance requirements in general

- Substance should be **appropriate for the activities performed**
- This requires a **case-by-case analysis**
- **Attitude of the tax authorities** of the other jurisdictions involved needs to be considered

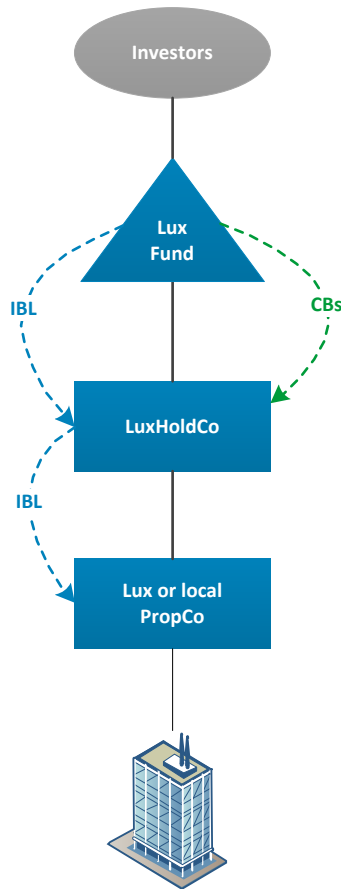
THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A FOREIGN TAX PERSPECTIVE



3. Substance requirements in an EU context

- Two major decisions of the CJEU in 2017 put **strict limitations to the scope of anti-abuse legislation in an EU context**
 - Decision on a (former) **PPT under French domestic tax law**
 - Decision on the **German anti-treaty/directive shopping rule**
- Anti-abuse legislation has to target “**wholly artificial arrangements**”

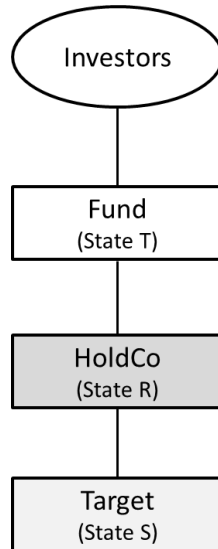
THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A TAX TREATY PERSPECTIVE



1. The PPT

- Recommendations regarding the **design of tax provisions and domestic tax rules** that should prevent tax treaty abuse
- **Multilateral instrument (MLI)** to implement recommendations in regard to Action 6
- Luxembourg merely agreed on the minimum standard (i.e. the **principal purpose test/PPT**)
- When a Luxembourg investment structure **lacks substance**, foreign tax authorities **may deny treaty benefits**

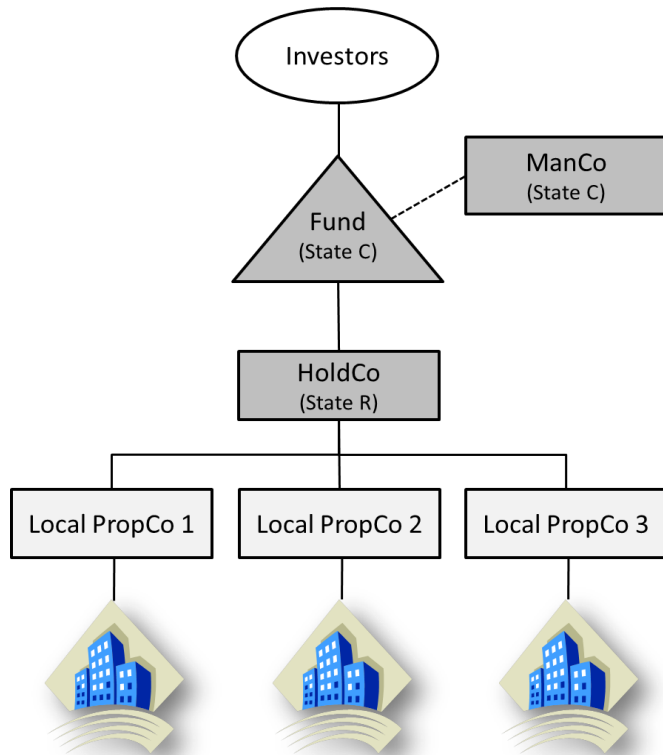
THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A TAX TREATY PERSPECTIVE



2. OECD Guidance regarding the PPT

- The 2017 Update to the Commentary on the OECD Model provides guidance on the interpretation and the application of the PPT
- Three examples depicting different **cases of alternative investments** are of particular relevance:
 - **Investment platform**
 - **Real estate fund**
 - **Securitization vehicle**
- In each of these examples, it is concluded that the **PPT should not be applicable**

THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A TAX TREATY PERSPECTIVE



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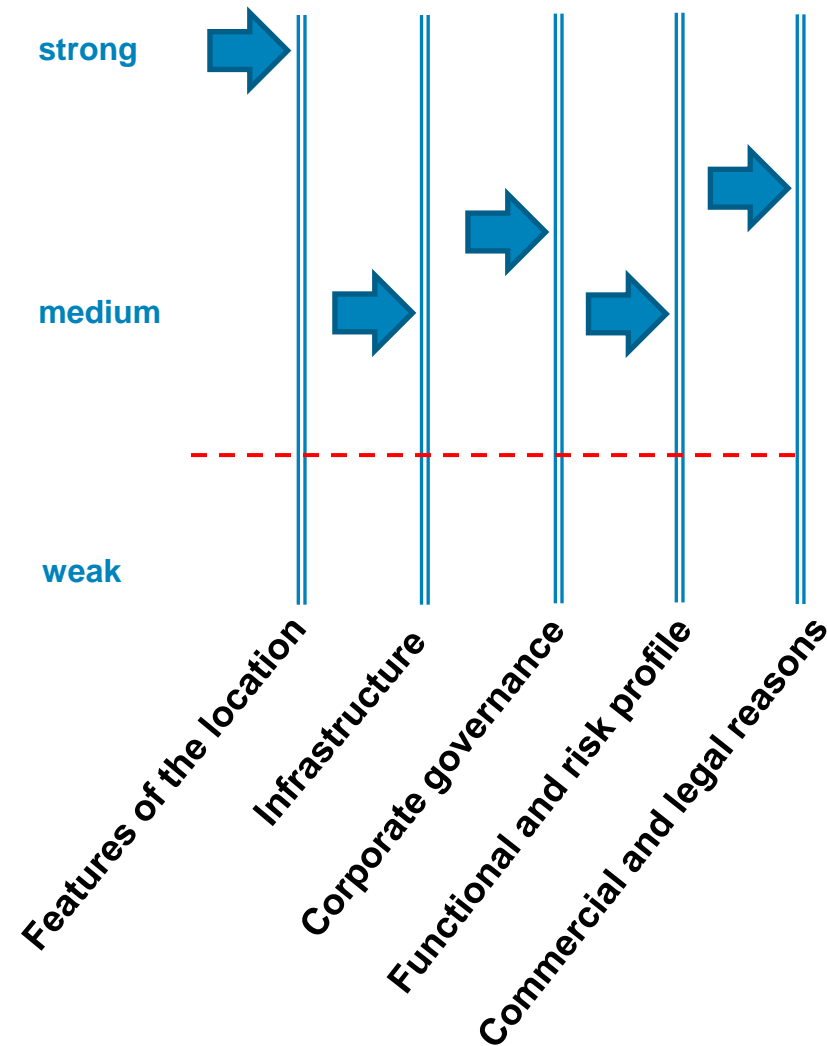
THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A TAX TREATY PERSPECTIVE



3. CJEU Case law

- When it comes to PPTs implemented in tax treaties between EU Member states, the **recent CJEU case law** on anti-abuse legislation should limit the scope
- Anti-abuse legislation has to target “**wholly artificial arrangements**”

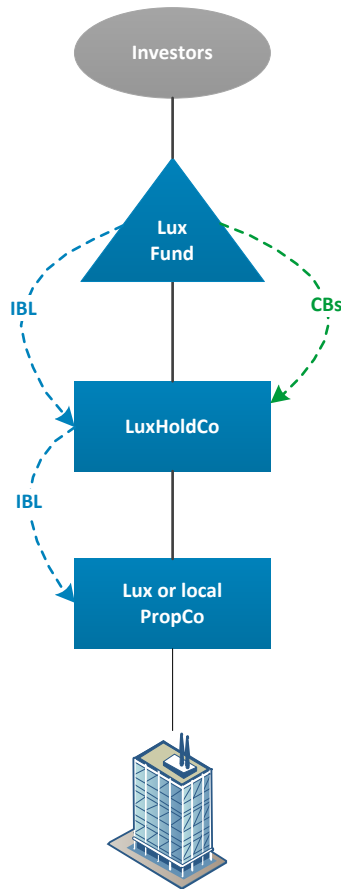
THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A TAX TREATY PERSPECTIVE



4. Impact on Luxembourg structures in general

- The application of the PPT needs to be **analysed on a case-by-case basis**
- Recent CJEU case law puts **significant limitations to the application of the PPT in an EU context**
- Even in a **non-EU context**, the **guidance provided in the Commentary** to the OECD Model concludes that the PPT **should generally not apply** in case of alternative investments

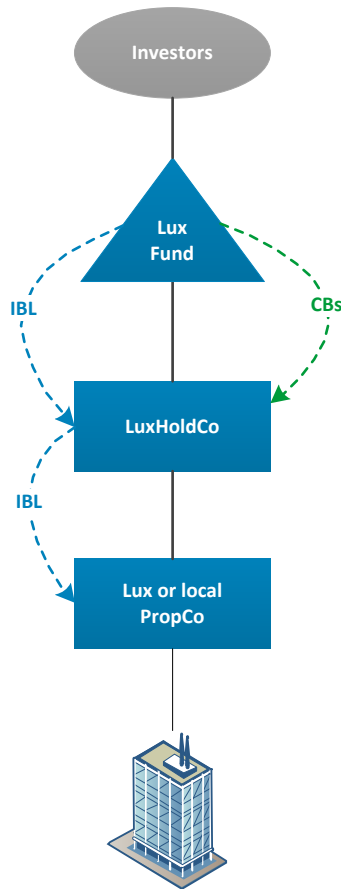
THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A TAX TREATY PERSPECTIVE



5. Beneficial ownership

- Relevant when it comes to the payment of **dividends, interest and royalties**
- Tax treaties generally **restrict the taxing right of the source state**
- Such restriction is **subject to the condition that the recipient of the income is the beneficial owner** thereof
- **Agents, nominees or conduit companies** acting as a fiduciary or an administrator would **not benefit from reduced/zero WHT rates**

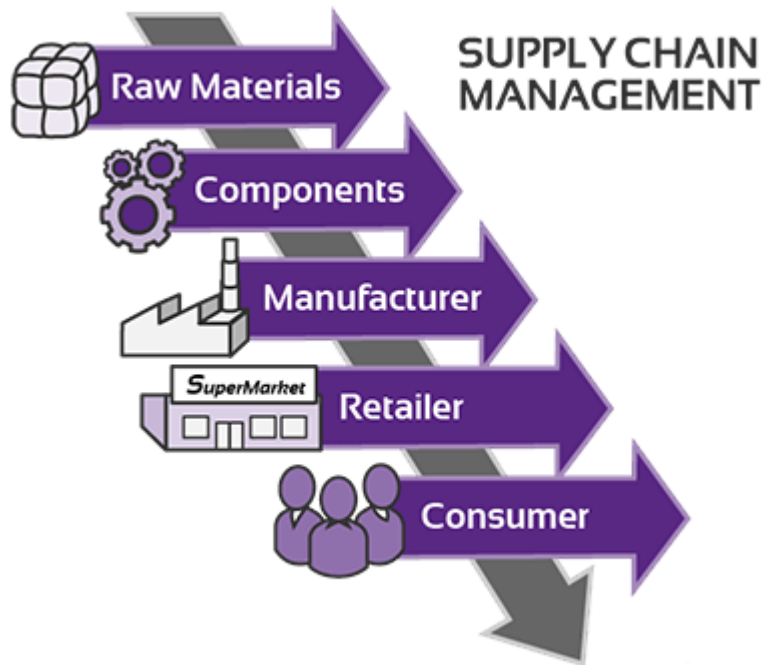
THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A TRANSFER PRICING PERSPECTIVE



1. Concepts relating to substance

- **Functions** performed, **risks** assumed and **assets** used
- **Control over risk**
- **Financial capacity** to bear the risk
- **People functions**

THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A TRANSFER PRICING PERSPECTIVE

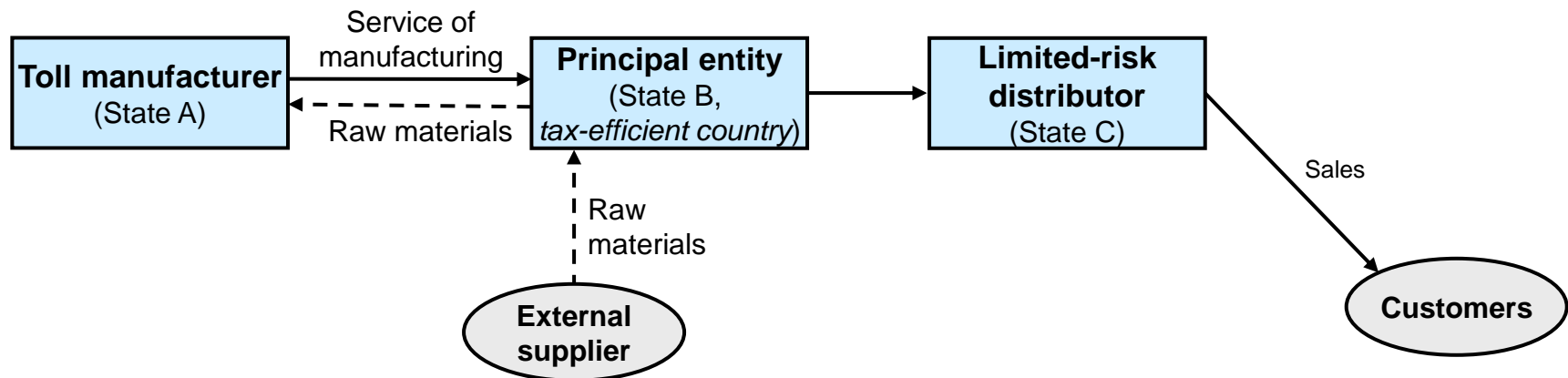


2. Principal structure

- **Business models** and related functional and risk profiles
- With **functions and risks** goes **return**
- **Principle structures** are often employed by MNEs

THE IMPORTANCE OF SUBSTANCE IN INTERNATIONAL TAX REQUIREMENTS FROM A TRANSFER PRICING PERSPECTIVE

2. Principal structure



The image features a hand at the bottom holding a solid blue rectangular sign. The sign contains the text 'DEFINING THE RIGHT LEVEL OF SUBSTANCE' in white, bold, sans-serif capital letters. The background is white and filled with several interlocking gears of different sizes, drawn with black outlines. The gears are arranged in a way that they appear to be meshing together, with some partially obscured by the blue sign.

**DEFINING THE RIGHT
LEVEL OF SUBSTANCE**

DEFINING THE RIGHT LEVEL OF SUBSTANCE

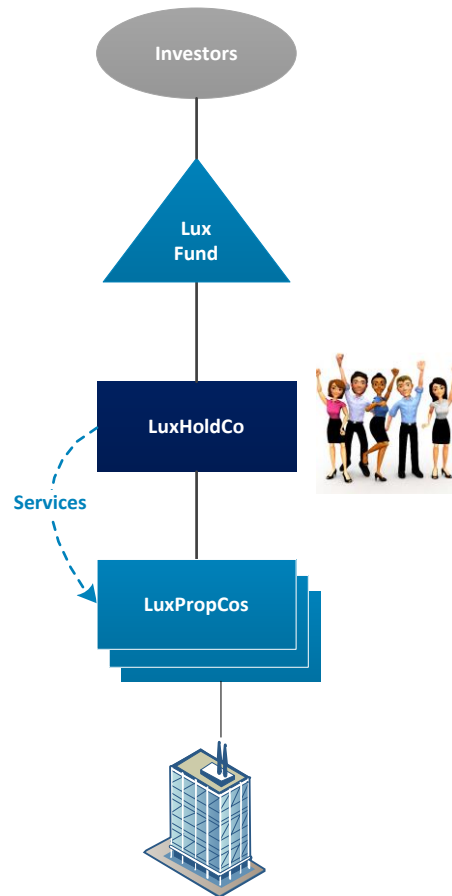
KEY ISSUES



- There is **no “one-size fits all” approach** to substance. Instead, the level of substance has to be **tailored to each investment structure**
- Substance requirements depend, in particular, on the following aspects:
 - the investment/business activities
 - the magnitude of the activities
 - the items of income that will be realized
 - the jurisdictions involved, and
 - the investment strategy
- There are **different ways to provide substance** to an investment structure

DEFINING THE RIGHT LEVEL OF SUBSTANCE

SUBSTANCE MODELS

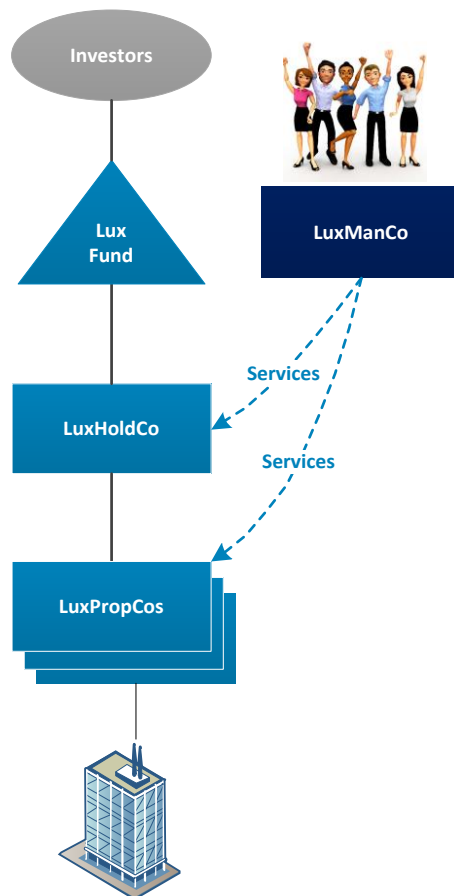


1. Master holding company

- Investments are structured via a **Master holding company** (LuxHoldCo)
- **Substance** is organized **at the level of LuxHoldCo**
- **LuxHoldCo renders services** to the property companies

DEFINING THE RIGHT LEVEL OF SUBSTANCE

SUBSTANCE MODELS

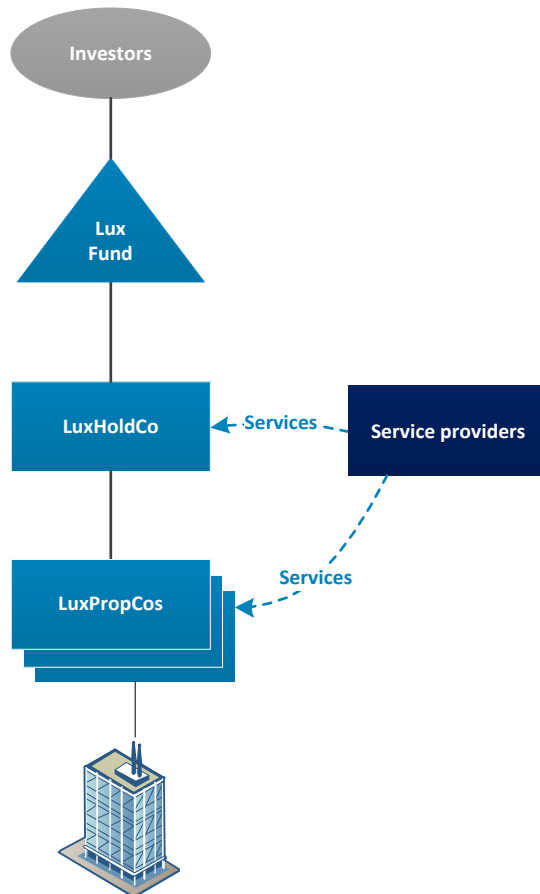


2. Management or service company

- Asset manager with a **Luxembourg management company** (LuxManCo)
- LuxManCo has significant substance and **provides services** to different investment structures

DEFINING THE RIGHT LEVEL OF SUBSTANCE

SUBSTANCE MODELS

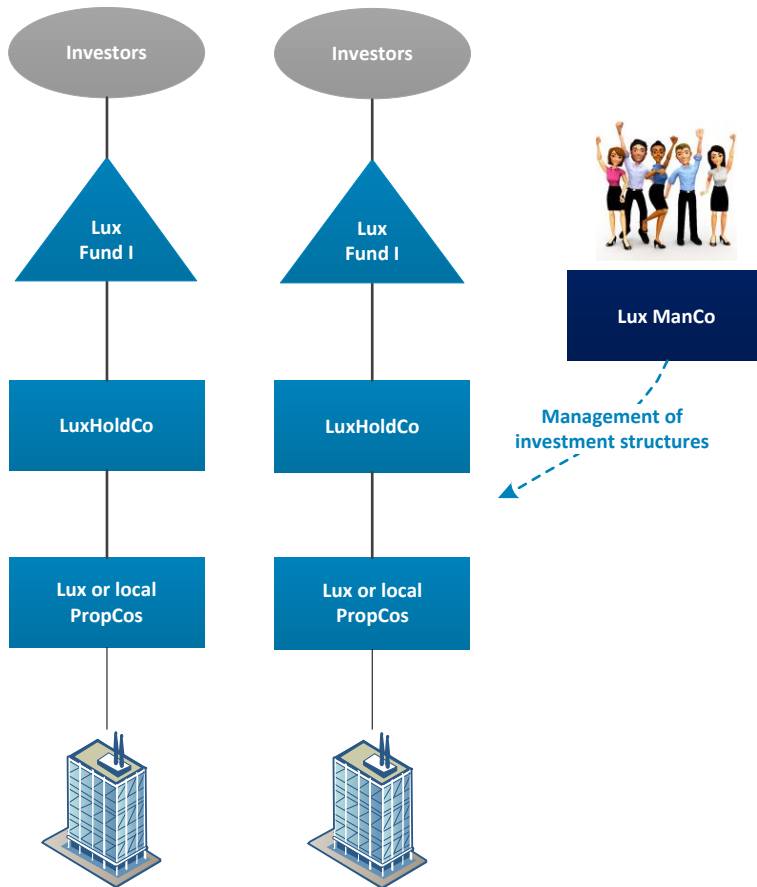


3. Outsourcing model

- **Certain functions are outsourced** to Luxembourg service providers
- Those functions are **monitored by the directors** of the Luxembourg companies

DEFINING THE RIGHT LEVEL OF SUBSTANCE

CASE STUDIES

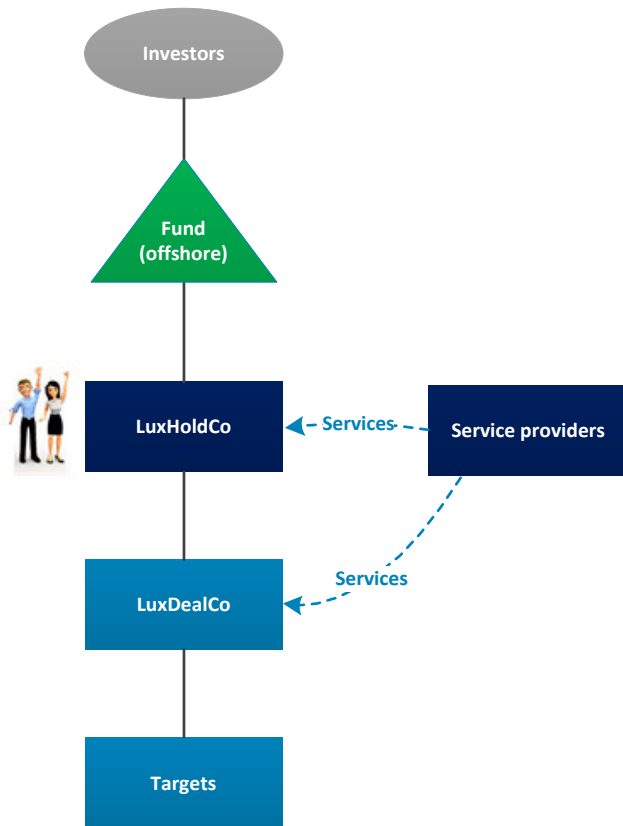


1. The pan-European real estate funds

- Structuring of investments in **pan-European real estate portfolios** via Luxembourg fund and holding structures
- Substance is organized in a **management company** (LuxManCo) that renders services for the benefit of all Luxembourg entities

DEFINING THE RIGHT LEVEL OF SUBSTANCE

CASE STUDIES

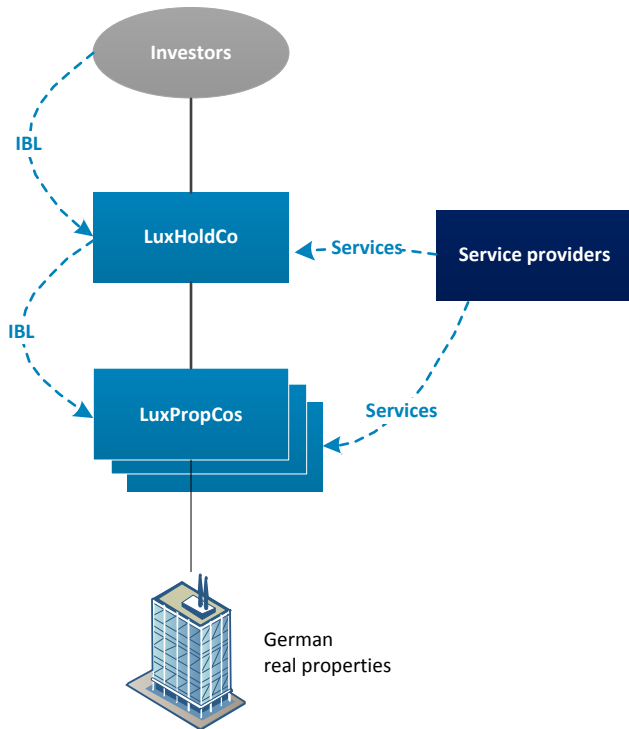


2. The private equity fund platform

- Investments in **European target companies and groups** are structured via an offshore fund and a Luxembourg master holding company (LuxHoldCo) and Luxembourg deal companies (LuxDealCos)
- LuxHoldCo has sufficient staff to **manage the activities of LuxHoldCo and the Luxembourg subsidiaries**
- Where functions are **outsourced to Luxembourg service providers**, the employees of LuxHoldCo are **reviewing and monitoring** the work performed

DEFINING THE RIGHT LEVEL OF SUBSTANCE

CASE STUDIES

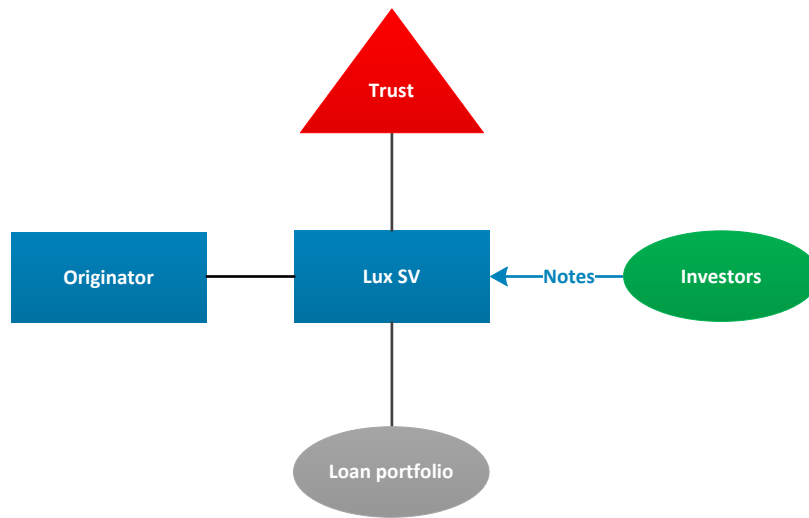


3. Investments into German real estate

- Investment via a Luxembourg holding company (LuxHoldCo) and Luxembourg property companies (LuxPropCos) into **German real properties**
- Management of **activities performed** by LuxPropCos in **Germany**
- Functions such as accounting, tax advice and compliance as well as domiciliation are **outsourced to qualified Luxembourg service providers**
- The directors of the Luxembourg companies are **supervising and reviewing all activities that are outsourced**

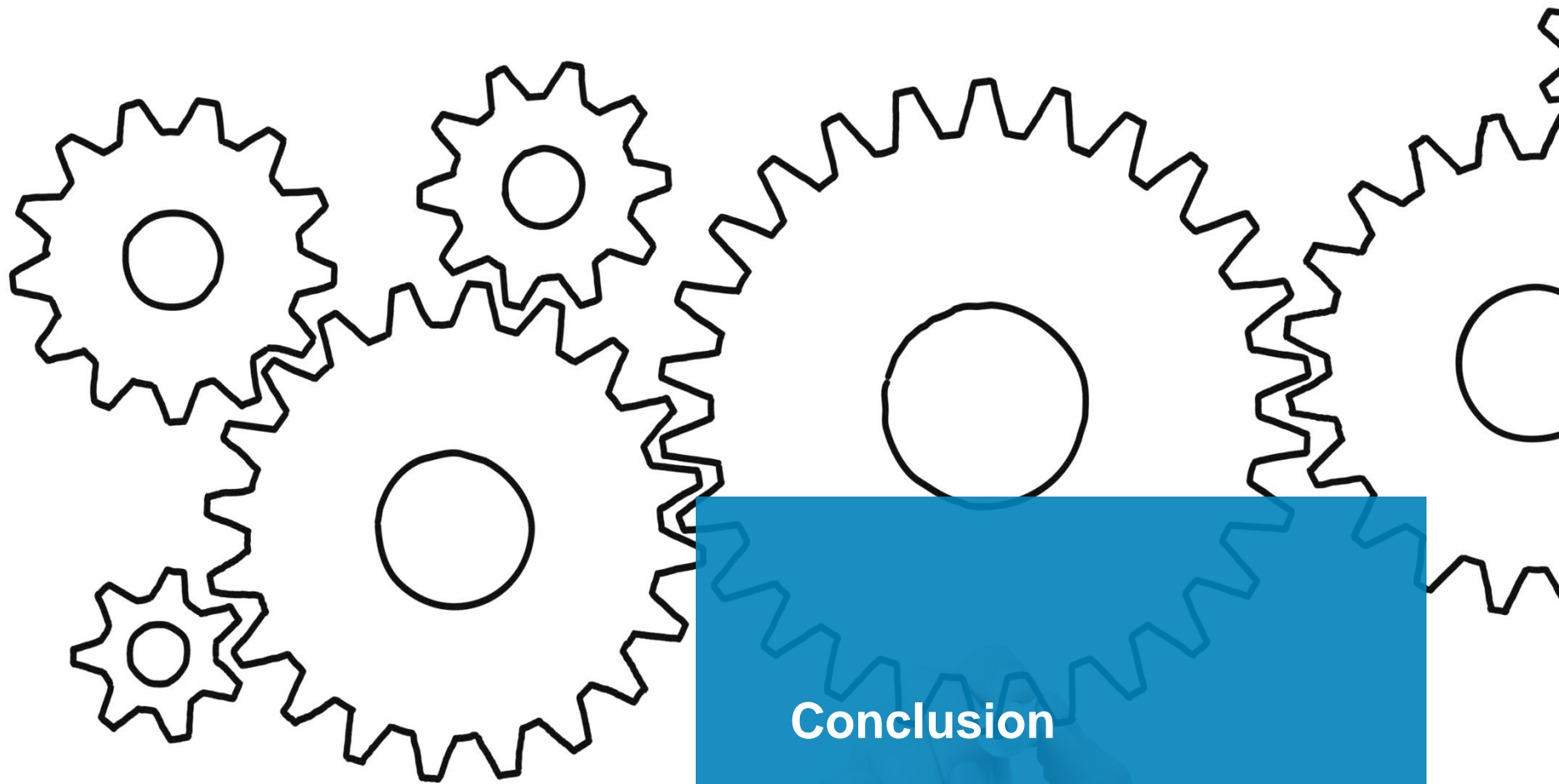
DEFINING THE RIGHT LEVEL OF SUBSTANCE

CASE STUDIES



4. The securitization company

- **Securitization transactions** structured via a Luxembourg securitization vehicle (LuxSV)
- **Strong corporate governance** ensured via qualified Luxembourg directors
- **Outsourcing** of certain functions **but full involvement of the board of directors** in the management of LuxSV
- **Beneficial ownership**



Conclusion

CONCLUSION



- The BEPS Project has a **significant impact on the international tax landscape**
- **Enhanced transparency** in international tax and **anti-abuse rules** in tax treaties and under foreign tax law pressures Luxembourg companies to implement **appropriate substance**
- There is **no "one size fits all"** solution and the right level of substance has **to be determined on a case-by-case basis**
- Ultimately, **investment structures** need to be **more tailor-made** than in the past, responding to foreign tax requirements

QUESTIONS ?



KEY TEAM MEMBERS



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About Romain

- 11 years of experience in structuring Pan-European investments and coordinating tax implementation for a wide range of institutional investors in the Private Equity and Real Estate sectors
- Also active with multinationals in the oil & gas industry as well as in the telecommunications sector
- Extensive experience in structured finance, corporate restructuring, and family offices

Qualifications

- Admitted to practice as an Attorney and Counselor-at-law in New York (USA)
- Master's degree in Tax law from the Université Panthéon Sorbonne (Paris I)
- Master's degree in Business Law from Université Panthéon Assas (Paris II)
- LLB degree from the London School of Economics and Political Science
- Member of the Tax Committee of the American Bar Association and of the New York State Bar Association

Languages

- English, French

ABOUT THE PRESENTER



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About Oliver

- 15 years of experience in Luxembourg and international taxation with a focus on Alternative Investments (Private Equity, Real Estate, Sovereign Wealth Funds, Hedge Funds), Mergers & Acquisitions and Multinational Groups
- Advising clients on all direct tax aspects regarding deal structuring, maintenance, reorganizations and exit planning
- Head of Transfer Pricing and the German Desk
- Member of the Global Transfer Pricing Group of the Taxand Network focusing on the sharing of transfer pricing developments in different jurisdictions and the design of common templates and approaches (e.g. the master file/local file concept)
- Publication of more than 160 articles and books on Luxembourg and international taxation including Transfer Pricing and the OECD Base Erosion and Profit Shifting (“BEPS”) Project (see www.atoz.lu/media-room)
- Regular speaker at conferences and lecturer with House of Training

Qualifications

- Chartered accountant in Luxembourg (“*Expert Comptable*”)
- Certified German tax advisor (“*Steuerberater*”)
- Post-graduate degree in Luxembourg Tax
- Degree in business administration with a major in tax from the University of Applied Sciences of Trier (Germany)

Languages

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