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Eligibility for Treaty Benefits Under The Luxembourg-U.S. Income Tax Treaty

by John Venuti, Jason Connery, Douglas Poms, and Alexey Manasuev

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SPECIAL REPORTS

Eligibility for Treaty Benefits Under the Luxembourg-U.S. Income Tax Treaty

by John Venuti, Jason Connery, Douglas Poms, and Alexey Manasuev

John Venuti and Jason Connery are principals, Douglas Poms is a director, and Alexey Manasuev is a manager in KPMG's Washington National Tax International Corporate Services Group.

The information contained in this article is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

To be entitled to benefits under income tax treaties, companies must satisfy eligibility requirements. This article includes flowcharts to assist practitioners in navigating the eligibility requirements of the Luxembourg-U.S. income tax treaty applicable to companies.

Income tax treaties may exempt business income from source-country income taxes and may exempt from tax, or reduce domestic withholding tax rates on, some payments between residents of countries that are parties to an income tax treaty. U.S. income tax treaties contain various eligibility requirements. A company claiming benefits must not only be a resident of the tax treaty partner, but must also satisfy the limitation on benefits provision included in most U.S. income tax treaties.

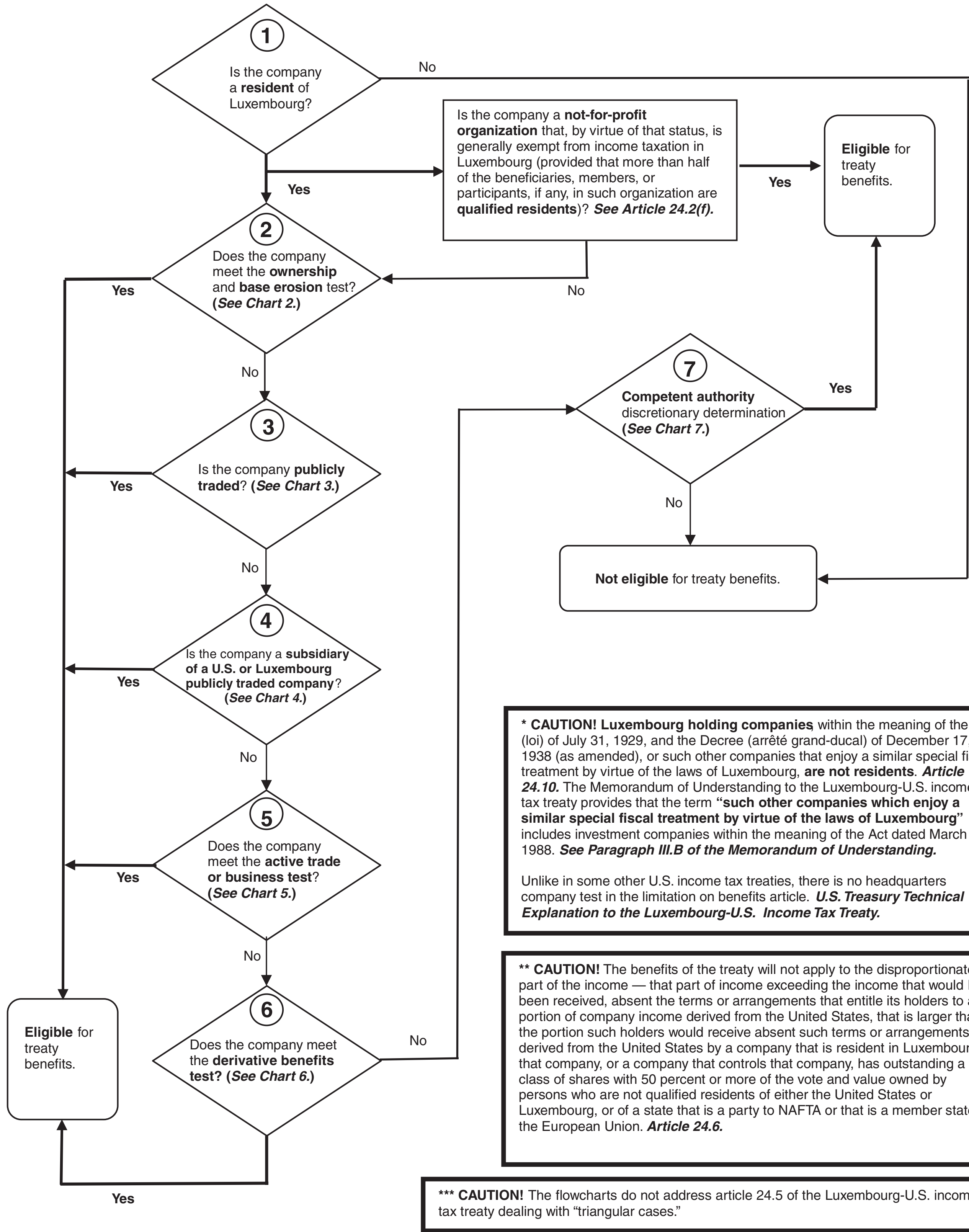
This article contains decision-making flowcharts that focus on the eligibility of companies claiming benefits under the Luxembourg-U.S. income tax treaty.[1] However, this article does not address the eligibility for treaty benefits of entities that are partnerships or are otherwise transparent for U.S. or Luxembourg tax purposes. Also, the flowcharts do not address triangular cases under article 24.5 of the Luxembourg-U.S. income tax treaty. The article is based on the provisions of the Luxembourg-U.S. income tax treaty, the memorandum of understanding to the treaty, and the U.S. Treasury technical explanation to the treaty.

This article is the third in a series of articles that provide flowcharts to assist practitioners in determining a company's eligibility for tax treaty benefits under the LOB provision of specific U.S. income tax treaties and, when applicable, in determining eligibility for a 0 percent withholding tax rate on dividend payments to such company. (For prior coverage, see *Tax Notes Int'l*, Jan. 14, 2008, p. 181, *Doc 2007-27516*, or *2008 WTD 12-10*; and *Tax Notes Int'l*, Feb. 11, 2008, p. 523, *Doc 2008-773*, or *2008 WTD 33-10*.) Because the Luxembourg-U.S. income tax treaty does not provide for a 0 percent dividend withholding tax rate, this article addresses only the general eligibility of companies for treaty benefits under the LOB provision (article 24) of the Luxembourg-U.S. income tax treaty.

The article contains seven flowcharts analyzing the LOB provision as applied to companies. The flowcharts may serve as a useful practice tool for practitioners and taxpayers. Although the flowcharts provide a comprehensive review of applicable provisions in the Luxembourg-U.S. income tax treaty, taxpayers and their tax advisers should carefully evaluate each case and make a determination of whether the requirements of the treaty are met based on all facts and circumstances. ◆

[1]Convention Between the Government of the United States of America and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, signed Apr. 3, 1996. (For the income tax treaty, see *Doc 96-10286* or *96 TNI 67-44*.)

Chart 1. Eligibility for Treaty Benefits Under Article 24 (LOB) of Luxembourg-U.S. Tax Treaty



* **CAUTION! Luxembourg holding companies**, within the meaning of the Act (loi) of July 31, 1929, and the Decree (arrêté grand-ducal) of December 17, 1938 (as amended), or such other companies that enjoy a similar special fiscal treatment by virtue of the laws of Luxembourg, **are not residents**. ***Article 24.10.*** The Memorandum of Understanding to the Luxembourg-U.S. income tax treaty provides that the term **"such other companies which enjoy a similar special fiscal treatment by virtue of the laws of Luxembourg"** includes investment companies within the meaning of the Act dated March 30, 1988. ***See Paragraph III.B of the Memorandum of Understanding.***

Unlike in some other U.S. income tax treaties, there is no headquarters company test in the limitation on benefits article. ***U.S. Treasury Technical Explanation to the Luxembourg-U.S. Income Tax Treaty.***

** **CAUTION!** The benefits of the treaty will not apply to the disproportionate part of the income — that part of income exceeding the income that would have been received, absent the terms or arrangements that entitle its holders to a portion of company income derived from the United States, that is larger than the portion such holders would receive absent such terms or arrangements — derived from the United States by a company that is resident in Luxembourg if that company, or a company that controls that company, has outstanding a class of shares with 50 percent or more of the vote and value owned by persons who are not qualified residents of either the United States or Luxembourg, or of a state that is a party to NAFTA or that is a member state of the European Union. ***Article 24.6.***

*** **CAUTION!** The flowcharts do not address article 24.5 of the Luxembourg-U.S. income tax treaty dealing with "triangular cases."

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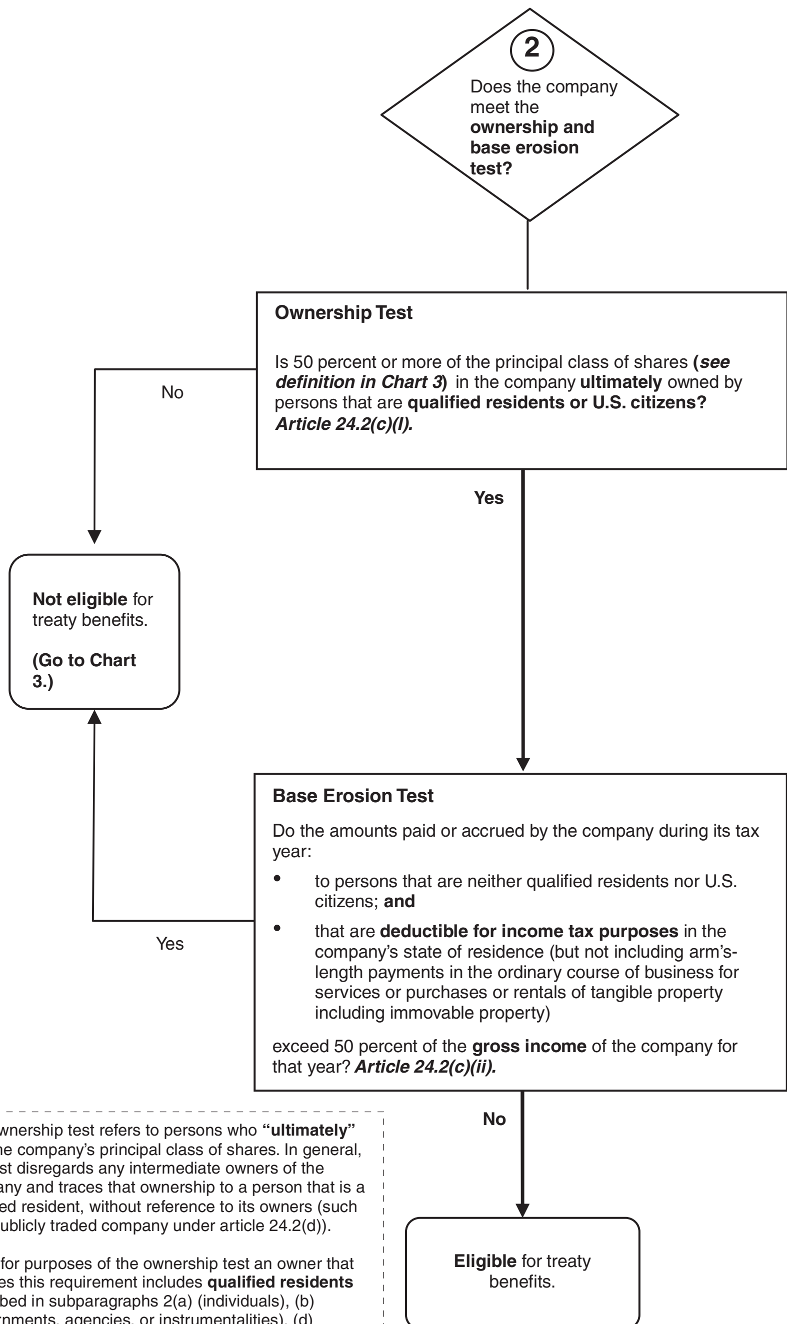
Chart 2. Ownership and Base Erosion Test Under Article 24.2(c) (LOB) of Luxembourg-U.S. Tax Treaty



"Qualified resident" means any person that is entitled to the treaty benefits under ***Article 24.2*** of the Luxembourg-U.S. income tax treaty, as follows:

(a) certain individuals;
(b) governments, agencies, or instrumentalities;
(c) persons meeting the ownership and base erosion test **(*see Chart 2*)**;
(d) publicly traded companies **(*see Chart 3*)**;
(e) subsidiaries of publicly traded companies **(*see Chart 4*)**; or
(f) certain not-for-profit organizations **(*see Chart 1*)**.

The United States may consider a person not to be a **qualified resident** unless such person demonstrates that a percentage of its shares (including shares not issued in registered form, *i.e.*, "bearer shares") necessary to satisfy the specified ownership threshold is beneficially owned by **qualified residents** or, when relevant, by **residents of a member state of the European Union** or a **state that is a party to NAFTA**. ***Memorandum of Understanding, Paragraph III.D.***

The term **"deductible for income tax purposes"** is not defined in the treaty. However, the U.S. Treasury Technical Explanation to the Luxembourg-U.S. Income Tax Treaty contains the following example that is helpful in understanding the purpose of this requirement. **Example**: A third-country resident could lend funds to a Luxembourg-owned Luxembourg corporation to be reloaned to the U.S. company. The U.S.-source interest income of the Luxembourg corporation would be exempt from U.S. withholding tax under article 12 (Interest). While the Luxembourg corporation would be subject to Luxembourg corporate income tax, its taxable income could be reduced to near zero by the deductible interest paid to the third-country resident. If, under Luxembourg law or a tax treaty between Luxembourg and the third country, that interest income is exempt from Luxembourg tax, the U.S. treaty benefit regarding the U.S.-source interest income will have flowed to the third-country resident inappropriately, with no reciprocal benefit to the United States from the third country. ***U.S. Treasury Technical Explanation to the Luxembourg-U.S. Income Tax Treaty.***

The ownership test refers to persons who **"ultimately"** own the company's principal class of shares. In general, this test disregards any intermediate owners of the company and traces that ownership to a person that is a qualified resident, without reference to its owners (such as a publicly traded company under article 24.2(d)).

Thus, for purposes of the ownership test an owner that satisfies this requirement includes **qualified residents** described in subparagraphs 2(a) (individuals), (b) (governments, agencies, or instrumentalities), (d) (publicly traded companies), and (f) (not-for-profit organizations), because such persons are considered **qualified residents** without reference to their ownership (if any). Ownership traced to any other person would not count toward satisfying the ownership test. At least 50 percent of such owners must be **qualified residents** or U.S. citizens. ***U.S. Treasury Technical Explanation to the Luxembourg-U.S. Income Tax Treaty.***

The term **"gross income"** is not defined in the treaty. However, the United States will ascribe the meaning to the term that it has under the U.S. law. In general, the term should be understood to mean gross receipts (net of returns and allowances less the cost of goods sold). ***U.S. Treasury Technical Explanation to the Luxembourg-U.S. Income Tax Treaty.***

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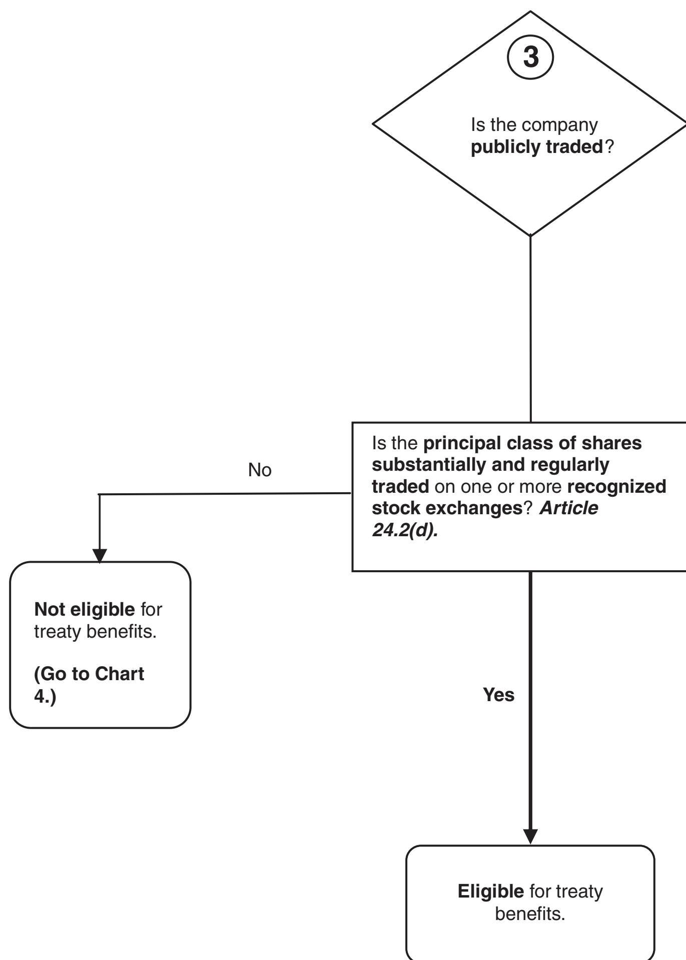
Chart 3. Publicly Traded Company Test Under Article 24.2(d) (LOB) of Luxembourg-U.S. Tax Treaty



The term **"principal class of shares"** is not defined in the treaty. It is understood that the term refers generally to the ordinary or common shares of a company, provided that such class represents the majority of the voting power and value of the company. If more than one group of classes can be identified that accounts for more than 50 percent of the shares, it is only necessary that one such group satisfy the requirements of this provision for the company to be entitled to benefits. If no single class represents the majority of the company's voting power and value, the principal class of shares will be those classes that in the aggregate possess more than 50 percent of voting power and value. ***U.S. Treasury Technical Explanation to the Luxembourg-U.S. Income Tax Treaty.***

The shares in a class of shares are considered to be **"substantially and regularly traded"** on one or more recognized stock exchanges in a tax year if the aggregate number of shares of that class traded on such stock exchange or exchanges during the previous tax year is at least 6 percent of the average number of shares outstanding in that class during that tax year. ***Article 24.2(d).***

The term **"recognized stock exchange"** means:

(i) any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange for purposes of the U.S. Securities Exchange Act of 1934;

(ii) the Luxembourg stock exchange (***not applicable with respect to closely held companies***);

(iii) the NASDAQ System owned by the National Association of Securities Dealers (***not applicable with respect to closely held companies***); and

(iv) any other stock exchange agreed upon by the competent authorities (***not applicable to closely held companies in cases when competent authorities of the United States and Luxembourg reached the respective mutual agreement***). ***Article 24.8(a)***.

The Memorandum of Understanding to the Luxembourg-U.S. Income Tax Treaty clarifies that the term **"recognized stock exchange"** includes the principal stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, London, Madrid, Milan, Paris, Sydney, Tokyo, and Toronto. ***See Paragraph III.A of the Memorandum of Understanding.***

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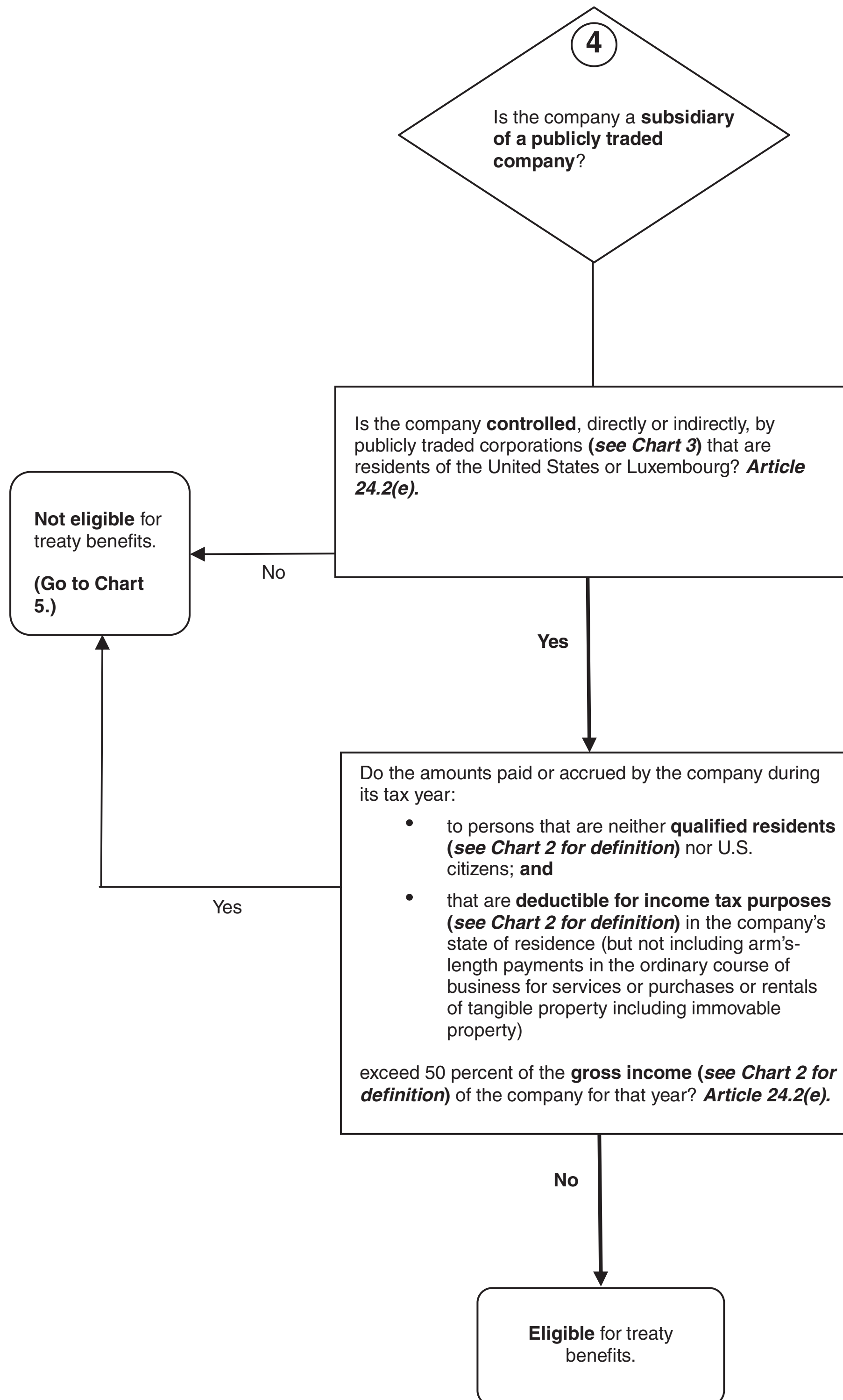
Chart 4. Subsidiary of a Publicly Traded Company Test Under Article 242(e) (LOB) of Luxembourg-U.S. Tax Treaty



The term **"control"** refers to the ability to influence the actions of the company, but does not require a majority ownership. ***U.S. Treasury Technical Explanation to the Luxembourg-U.S. Income Tax Treaty.***

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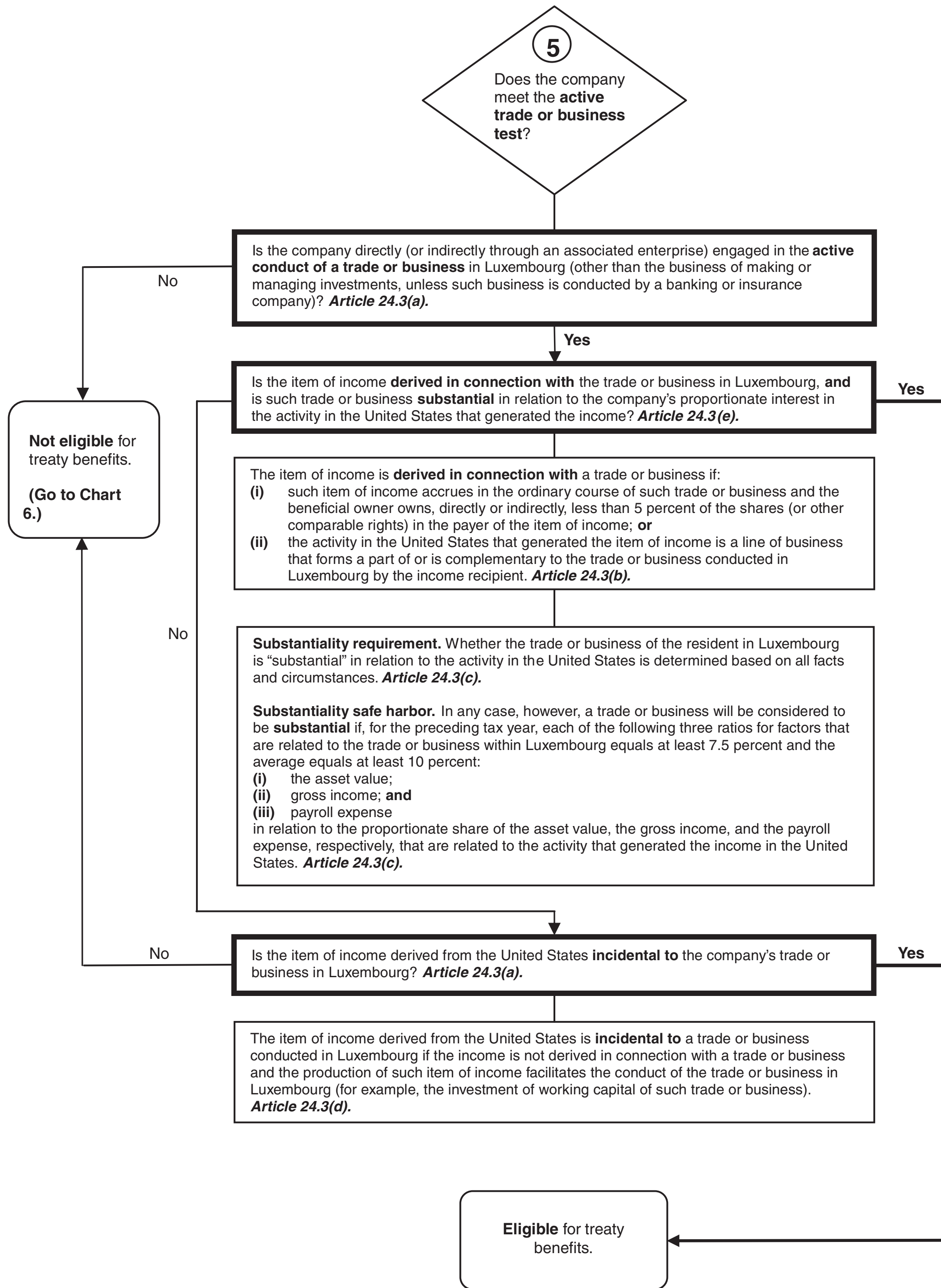
Chart 5. Active Trade or Business Test Under Article 24.3 (LOB) of Luxembourg-U.S. Tax Treaty (Only benefits regarding a particular item of income can be granted)



The term **"active trade or business"** is not defined in the treaty or the U.S. Treasury Technical Explanation to the treaty. Absent the definition of this term in a treaty, some U.S. income tax treaties refer to section 1.367(a)-2T(b)(2) of the U.S. Treas. regulations for a definition of the term "*trade or business*."

If any separate factor does not meet the 7.5 percent test in the first preceding tax year, the average of the ratios for that factor for the three preceding tax years may be substituted. If the resident owns, directly or indirectly, less than 100 percent of an activity conducted in either the United States or Luxembourg, only the resident's proportionate interest in such activity will be taken into account for purposes of the substantiality test. ***Article 24.3(c).***

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Chart 6. Derivative Benefits Test Under Article 24.4 (LOB) of Luxembourg-U.S. Tax Treaty

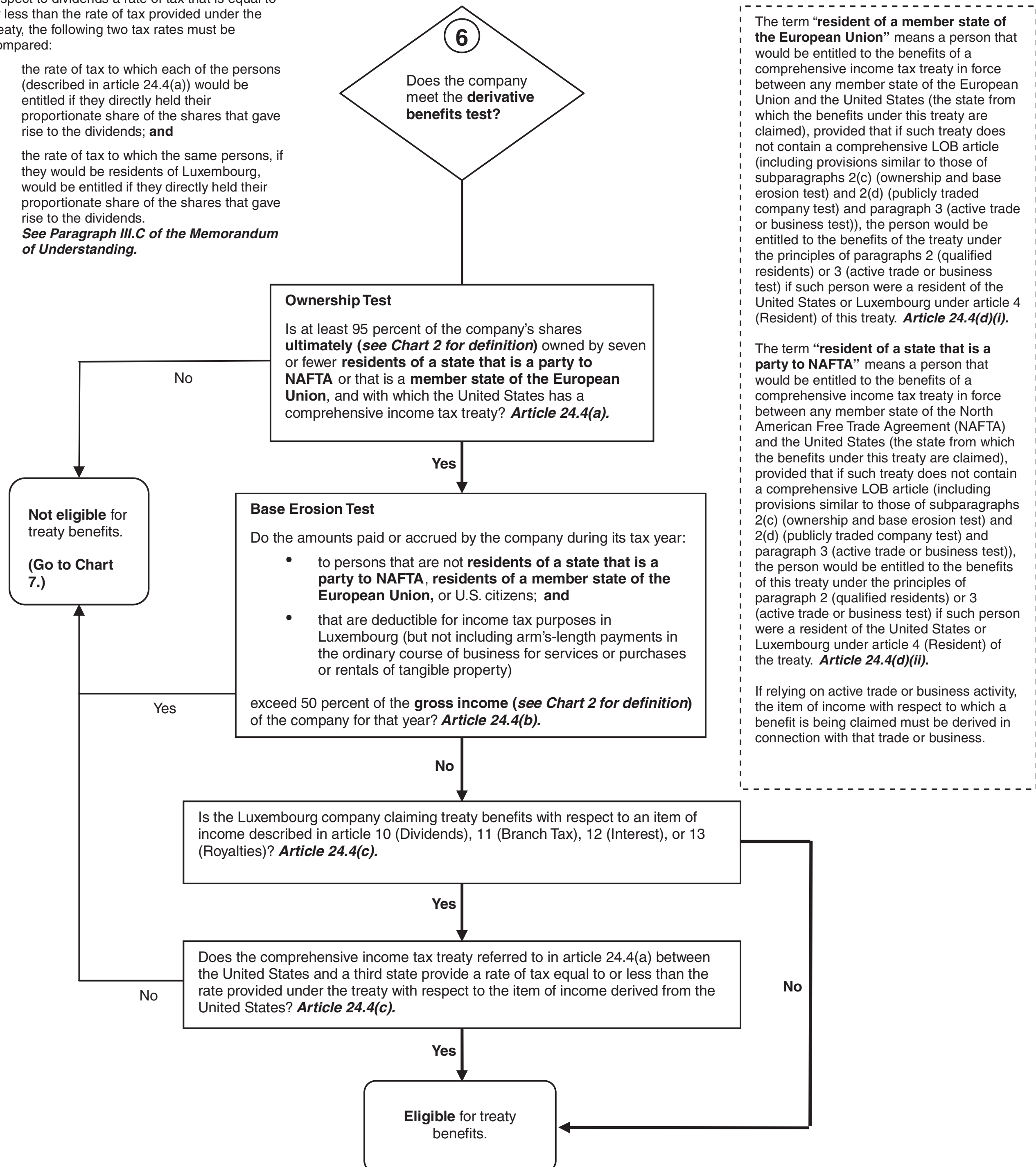

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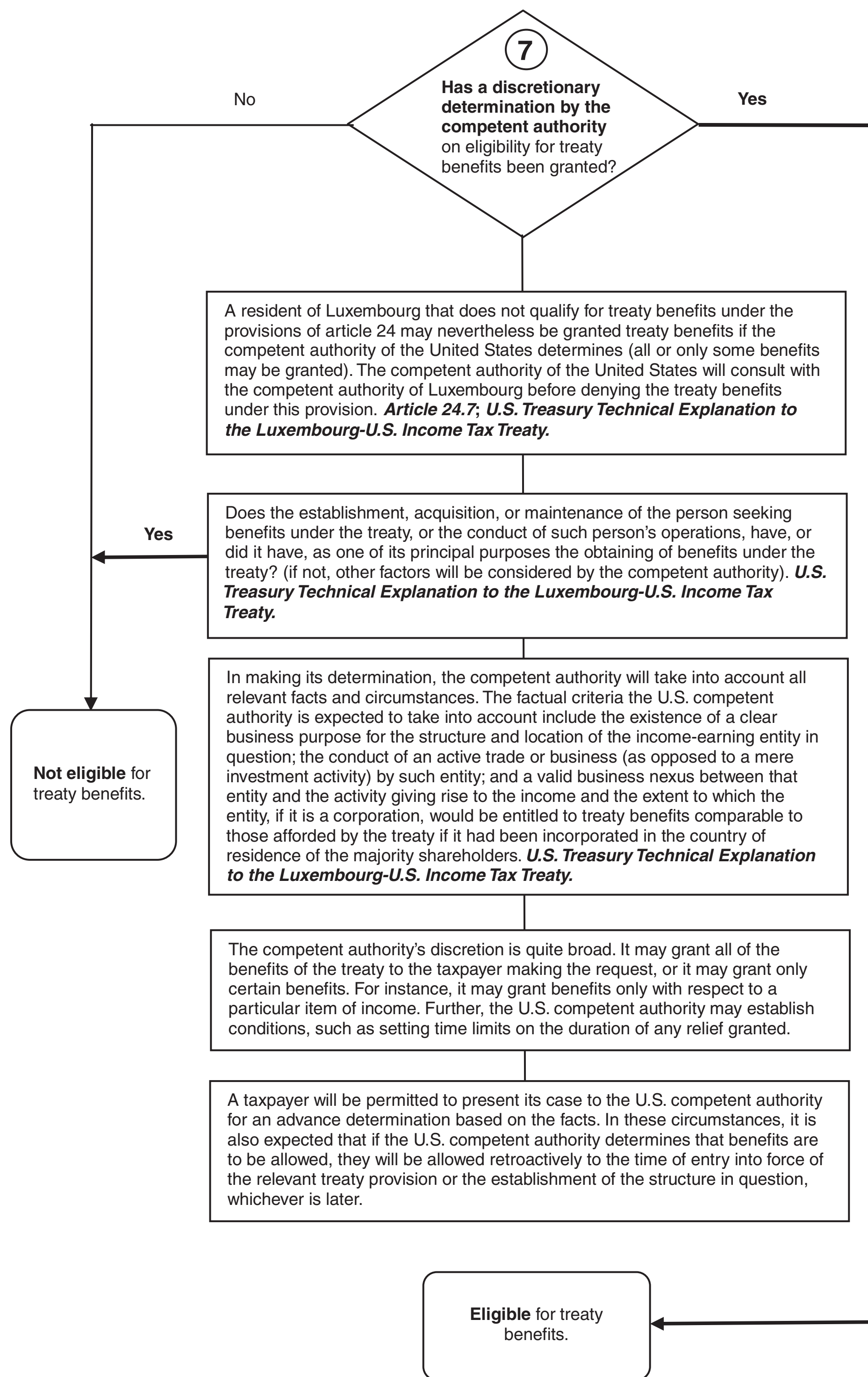
Chart 7. Discretionary Determination by the Competent Authority Under Article 24.7 (LOB) of the Luxembourg-U.S. Tax Treaty



Requesting competent authority assistance. A taxpayer may request the assistance of the U.S. competent authority under Rev. Proc. 2006-54. The U.S. competent authority may determine in its own discretion that the taxpayer qualifies for certain benefits under article 24 (LOB) of the Luxembourg-U.S. Income Tax Treaty.

There is a US $15,000 user fee for requesting a discretionary determination under the LOB provision. If a request is submitted for more than one entity, a separate user fee is charged for each entity. ***Rev. Proc. 2006-54, section 14.2.***

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