ATOZ TAX ADVISERS LUXEMBOURG

ATOZ TAX ALERT

New France-Luxembourg Double Tax Treaty

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On 20 March, 2018, France and Luxembourg signed a new Double Tax Treaty ("DTT"), which was released yesterday. The aim of the new DTT is to replace the existing one that was signed in 1958, and amended 4 times since then. The DTT follows the structure and, for the most part, the content of the 2017 OECD Model Tax Convention.

This tax alert provides an overview of the main provisions of the DTT, which will, in particular, bring along important changes regarding the taxation of real estate investments made by Luxembourg companies through dedicated French investment vehicles.

New Preamble and Principle Purposes Test

In line with the latest version of the OECD Model Tax Convention and the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or "MLI"), the following preamble is included in the DTT: the aim of the DTT is the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements).

In addition, in order to address some forms of treaty abuse, the DTT contains a principal purposes test ("PPT") in accordance with Actions 6 and 15 of the Base Erosion and Profit Shifting ("BEPS") Action Plan, and in line with the guiding principle of paragraph 9.5 of the Commentary included in 2017 OECD Model Tax Convention. Under this PPT, a DTT benefit will be denied if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction (subjective test). However, DTT benefits will still be granted if it can be demonstrated that granting such benefits, in the circumstances at hand, would remain in accordance with the object and purpose of the relevant provisions of the DTT (objective test). Given the complexity in interpreting and applying this provision which will have to be read in conjunction with EU law (as defined at several occasions by the Court of Justice of the EU), it is recommended to seek advice from a tax adviser when setting up cross-border investments.

Persons Covered and Tax Residence

As far as persons covered are concerned, tax transparent entities (partnerships) are excluded from the qualification of person for the DTT purposes. Nevertheless, the DTT could be applied to France or Luxembourg source income derived through a transparent entity located in Luxembourg or in a third State having concluded with the source State a convention on administrative assistance, subject to the condition that the tax transparent treatment of the partnership is also recognised by the third State. French partnerships subject to tax in France are excluded from this provision and are treated as tax residents of France for the purpose of the DTT.

As far as tax residence is concerned, the DTT amends the existing rules applicable in cases of conflict of company residence and provides that a company is considered as resident in the State in which its effective place of management is located.

Application of some DTT provisions to Collective Investment Vehicles ("CIVs")

Contrary to the current version of the tax treaty, the DTT expressly states (in its Protocol) that it will apply to CIVs under certain conditions. This approach is notably compliant with the OECD report "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles". The Protocol to the DTT provides that a CIV established in a Contracting State, to the extent it is assimilated to a CIV under the legislation of the other Contracting State, may be granted some of the DTT benefits under certain conditions. The CIV (e.g. a Luxembourg SICAV or SICAF) will be able to claim the benefits under articles 10 (dividends) and 11 (interest) in order to benefit from the reduced withholding tax ("WHT") rates on dividends and the exemption of WHT on interest, but only up to the portion of the units/shares held in the CIV by "good" or "qualifying" investors. "Good investors" are defined as investors resident in a country which has concluded a convention on administrative assistance in order to fight against tax fraud and tax evasion with the country in which the CIV invests. The DTT gives no indication as to the practical application of these conditions (how to calculate the portion of good investors? at what moment? etc.). Therefore, this provision seems very difficult to apply in the day to day practice of CIVs, especially for those held widely and/or for open-ended CIVs.

Permanent Establishment

The permanent establishment definition set forth in the DTT is now fully based on the BEPS definition. In this respect, the definition generally corresponds to the position taken by France and not to the one that Luxembourg defended, notably in relation to the MLI.

As a result, (1) the qualification of "dependent agent" is extended, (2) the scope of the preparatory and auxiliary activities exemption is based on a lighter BEPS option, (3) the anti-fragmentation rule which limits the preparatory and auxiliary exemption scope is introduced and, (4) anti-abusive splitting-up of contracts for construction site period computation purposes is also added.

Dividends

Under the DTT, dividends will be subject to a WHT of maximum:

- 0% if the beneficial owner is a company which directly holds at least 5% (previously 25% under the current DTT, but 10% under the EU Parent Subsidiary Directive) of the capital of the paying entity for a period of 365 days, including the day of the dividend payment;
- Domestic rate (currently 30% in France) if the dividend is paid out of tax exempt income or gains derived from immovable assets by an investment vehicle, established in a Contracting State, which distributes annually most of its income, if the beneficial owner of the dividend is resident in the other Contracting State and holds, directly or indirectly, a shareholding of 10% or more in the share capital of the investment vehicle;
- 15% in all other cases (including in cases where the beneficial owner of the dividend paid by the real estate investment vehicle described above, holds a participation of less than 10% in this vehicle).

The aim of this provision is to make sure that dividend distributions by French OPPCI and SIIC are subject to a WHT of either 15% or 30%, depending on the shareholding held by the Luxembourg resident company. This change will incontestably impact real estate investments made by Luxembourg companies in France.

Interest and royalties

Interest will only be taxable in the country of the recipient, and thus cannot be subject to WHT in the source country. This was already the case under the old DTT and is currently not particularly relevant given that both countries do not levy WHT on interest under their internal law.

Royalties will be taxable in the country of the recipient could also be subject to a WHT of maximum 5% in the source country, which is correspondingly the rate applicable under the old DTT.

Capital gains & real estate rich companies

In principle, gains derived from the alienation of movable assets are taxable in the Contracting State of residence of the alienator.

The new DTT slightly amends the specific provision applicable since 2017 (based on the 2014 Protocol) to capital gains realised on the sale of real estate rich companies. The change introduced in the DTT relates to when the 50% threshold of real estate assets needs to be assessed. According to the amended provision, capital gains derived by a resident of a Contracting State from the alienation of shares and similar rights in a company, deriving directly or indirectly more than 50 % of its value from immovable property situated in the other Contracting State at any time during the 365 days preceding the alienation, may be taxed in that other State. As under the current provision, the rule applies to shares or other rights held both in a company resident in one of the Contracting States and in a company resident in a third country.

The DTT also introduces a rule according to which gains derived by an individual resident in one of the Contracting States from the alienation of a substantial shareholding (i.e. a direct or indirect shareholding giving rights to at least 25% of the profits of the company) in the share capital of a company resident in the other Contracting State are taxable in this Contracting State and not in the residence State of the alienator if the individual was resident of the other Contracting State at any time during the 5 years preceding the alienation of the shareholding. It appears to us that the compliance of this rule with some European fundamental rights could be challenged.

Employment income

As far as employment income is concerned, even though the rule has been redrafted to follow the OECD Model Tax Convention wording, the rule remains that the income derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State, unless the employment is “effectively” exercised in the other Contracting State. In other words, a French tax resident employed by a Luxembourg employer is taxed in Luxembourg on his or her employment income, but only to the extent that the work is effectively performed in Luxembourg.

Here, it is worth mentioning that the situation of cross-border workers will be slightly amended due to the fact that the Residence State of the employee will not be able to challenge the taxation of the salary in the State of the employer as long as the number of days spent by the employee outside of the employment State does not exceed 29 days per year. While this may appear to be good news at first sight for French cross-border workers, it seems that in certain cases the practice of the French tax authorities has been even more flexible: in 2012, while responding to a parliamentary question, the French Minister of Economy mentioned that a French employee of a Luxembourg company would remain taxable in Luxembourg on his or her salary to the extent that the employee did not spend more than one day per week (i.e. approximately 50 days per year) working in France.

Pensions

As far as pensions are concerned, pensions paid out of a compulsory social security system will generally be taxed in the source country.

Methods to avoid double taxation

France generally applies the credit method, with certain limits, to avoid double taxation. The benefit of a tax credit corresponding to the French tax for a French resident is subject to an effective taxation in Luxembourg.

Luxembourg generally applies the exemption method. However, the credit method applies to dividends, royalties and income of artists and sportsmen.

Entry into force

The new DTT will enter into force as soon as France and Luxembourg have exchanged the instruments of ratification, following the ratification in their respective country. The new DTT will apply to taxes in relation to the calendar year, which will follow the entry into force of the DTT, i.e. to taxes in relation to the tax year 2019 at the earliest.

Implications

The DTT introduces significant changes, especially for real estate investment in France. Luxembourg taxpayers with investments in France or that plan to invest in France should seek advice from their tax adviser in order to analyse the potential impact of the new provisions on their investments.

Can we help? Do you have further questions?

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