Signature of a new Double Tax Treaty between France and Luxembourg: impact on the Asset Management industry

19 april 2018

In brief

On 20 March, the Luxembourg and French Governments signed a new double tax treaty ("DTT"), together with an accompanying Protocol (the "Protocol").

The new DTT seeks to modernise the current rules, which dated back to 1958 and remained quite far from OECD standards, despite several successive recent amendments.

The new DTT is fully compatible with BEPS. It implements the new approaches developed at the international level during the OECD/G20 BEPS Project, which are now reflected in the 2017 version of the OECD Model Tax Convention and in the Multilateral Convention to Implement Tax Treaty Related Measures ("the MLI") that France and Luxembourg signed in June 2017

More specifically, the new DTT redefines the concept of permanent establishment and introduces new rules on the taxation of dividends, interest and royalties. Finally, both French and Luxembourg Collective Investment Vehicles ("CIVs") will now enjoy limited access to the new DTT.

Several provisions of the DTT are likely to impact many French real estate investments held from Luxembourg, notably those involving French OPCIs. We will discuss this in more detail below and also invite you to refer to the PwC Real Estate dedicated news alert.

It is expected that the new tax treaty will enter into force on 1 January 2019 if the ratification procedure is implemented rapidly by both States.

In detail

CIVs are not residents (Article 4 of the DTT)...

The concept of "residency" for the purposes of applying the current DTT was not in line with the one used in the OECD Model as it was focusing on the concept of "place of effective management" rather than the taxpayer status of the resident.

The new DTT now follows the 2017 OECD Model, and defines a resident as a person "subject to tax."

For certain collective investment funds or pension funds, the French Administrative Supreme Court ruled that being "subject to tax" requires being effectively subject to tax without the possibility of an exemption that could be granted by another provision of local law. To that extent tax-exempt vehicles such as French or Luxembourg SICAV/FCP or Luxembourg Specialised Investment Funds ("SICAV SIF"), may not readily be considered in principle as "residents" within the meaning of the new DTT.

In practice this change in the residency definition results in denying treaty access to investment funds.

… but CIVs access DTT for dividends and interest (Paragraph 2 of the Protocol)

However, the Protocol signed on the same date grants access to DTT benefits to French and Luxembourg CIVs under certain conditions.

According to the legislation of the other Contracting State, if CIVs based in France or Luxembourg are assimilated to the CIVs of the other country, they may benefit from certain advantages of Article 10 (dividends) and 11 (interest) of the new DTT.

However, such benefits will only accrue to the portion of dividends or interest corresponding to rights in the CIVs held by "equivalent beneficiaries" investors.

Investors can be "equivalent beneficiaries" in other countries apart from France and Luxembourg. For that, an administrative agreement against tax evasion and avoidance is needed between a country and the country of source of dividends or interest.

DTT benefits are reserved for investors resident in a DTT member-state, in proportion to their shareholdings, that have already been put in place by existing treaties (i.e. United States, Germany). However, expand the benefits to another country, provided an administrative assistance be already in place, is uncommon. Falling into the anti-abuse provision inserted in Article 28 ("Principal Purpose Test") should be avoided.

Additionally, these requirements may be difficult to apply to open-ended CIVs, as it is often impossible to identify all investors and to document their tax residence.

In practice, the impact of these requirements should be limited to France, as CIVs generally benefit from a total exemption of withholding tax on interest and dividends paid to them (Santander case law – EUCJ, 12 May 2012), if certain conditions are met. In Luxembourg, a positive impact could be expected if the CIV also benefits from the changes concerning the withholding tax exemption on dividends under certain conditions (see below section "Treatment of dividends"). In fact, French CIVs investing in Luxembourg are currently subject to a withholding tax of 15%.

Treatment of dividends (Article 10 of the DTT)

The insertion of requirements similar to Article 8 of the MLI exempts dividends paid by a resident company to any company resident in the other member-state holding a participation of at least 5%, if such participation has been held for at least 365 days. In other cases, the "standard" reduced rate of 15% continues to apply, counting that the beneficiary is a tax resident within the meaning of the DTT.

Changes were also made in the definition of dividends under the DTT. It now includes any distribution that domestic law assimilates to a distribution of dividends. Then, as Luxembourg law does not treat liquidation proceeds as a distribution of dividends, there would be no local withholding tax.

Specific situation of French OPCIs and SIICs

The new DTT takes away the advantage of holding exempt French real estate investment vehicles via Luxembourg in order to comply with the standards of the MLI.

The following regime will now apply to dividends derived from real estate income paid by any fund vehicle or company that distributes most of its exempt income on an annual basis (such as French OPCIs and SIICs):

- WHT of 15% if the beneficial owner directly or indirectly holds less than 10% of such vehicle;
- WHT of 30% (current French WHT rate), if the beneficial owner holds more than 10%, save if the recipient is a collective investment fund comparable to a French fund. In this case, a 15% rate applies in French domestic law.

This major development will most likely lead to a significant reorganisation within the real estate sector. This will encourage exempt French investment funds to be held by collective investment funds.

Treatment of Interest (Article 11 of the DTT)

The new treaty provides for a 0% withholding tax rate on interest, instead of 10% in the previous treaty. This change should have little impact in practice though given the respective domestic legislations of both jurisdictions.

In line with the OECD model, the new requisites of Article 11 ensure that the benefit of the treaty is granted only in proportion to the part of the "arm's length" portion of the distributed interests. As such, where the rate of interest is considered excessive, concerning the two parties relationship, the portion of the interest considered excessive will be taxable in accordance with domestic law and other applicable provisions of the new agreement.

Treatment of Capital gains (Article 13 of the DTT)

Now, the new DTT predicts that gains realised upon alienation by individuals of substantial participations (i.e. exceeding 25% of the rights in the company's benefits) are taxable in the State of the company whose shares are transferred. However, this substantial participation clause only applies when the seller has been a resident of that State at some point within a five year period before the alienation.

As mentioned above, Luxembourg funds will not be treated as residents for purposes of the new Convention. In the event of the alienation of a substantial participation, held by such a fund in a French company, France should be able to apply its domestic requisites. Therefore, the capital gain would be taxable in France, whereas the capital gain would have previously fallen within the scope of Luxembourg tax if the fund's centre of effective management were located in Luxembourg. However, such taxation could be illegal as it discriminates regarding the situation of a French fund, which would be exempt.

Simultaneously, if a French CIV realises a speculative capital gain on a large Luxembourg participation (holding of less than 6 months), this capital gain should be taxable in Luxembourg based on domestic law.

Permanent Establishment (Article 5 of the DTT)

The requirements of the new DTT do not deviate from the principle that profits made by an enterprise resident in one country are taxable locally, unless business is made in another country through a permanent establishment. These requirements also reflect the French option, established under the MLI, and they go against the reservations communicated by the Luxembourgish government.

The definition of permanent establishment under the new DTT is in line with recent OECD work. In particular, the recommendations of Action 7, which concerns "measures to artificially avoid the status of permanent establishment", definition included in the MLI.

The definition of a dependent agent now includes a person who acts in a State on behalf of a foreign enterprise and who, in doing so, frequently enters into contracts or plays the leading role in their conclusion. The conclusions of contracts are made without the foreign company making significant changes. Those contracts are: (i) in the name of the foreign enterprise or (ii) for the transfer of ownership of property belonging to that foreign enterprise or for the concession of the right to use the property the foreign enterprise has the right to use or (iii) for the supply of services by this enterprise.

In the asset management industry, these changes could impact managers directly, as a once simple, unattended representative office could be transformed into a permanent establishment.

In the future, it will therefore be necessary to review the organisational strategy of fund managers regarding fund distribution, delegation of operational and advisory functions both in France and in Luxembourg. In fact, it turns out that some contracts will certainly have to be re-drafted.

Anti-abuse provisions

The new DTT establishes a general anti-abuse rule based on the "Principal Purpose Test" by providing an advantage cannot be granted under the DTT if it can reasonably be concluded, taking into account all the facts and circumstances of the situation. The granting of that benefit was one of the principal purposes of an arrangement or transaction unless it is established that granting the benefit in those circumstances is consistent with the object and purpose of the provisions of the tax treaty.

This clause will give the French tax administration an alternative to the French anti-abuse provisions, which are formulated in a more restrictive manner. A dedicated investment vehicle set up to benefit from the favourable provisions of the new Convention could therefore fall under them.

In addition, Article 4 on Residence includes an anti-abuse clause based on beneficial ownership. Referring specifically to the trustee, this section applies where the beneficiary of an income item that would otherwise qualify for residence would only be the "apparent" beneficiary. In this case, the so-called apparent beneficiary cannot be considered a resident and cannot avail himself of the convention for the income in question (unless the beneficial owner himself is a resident of the same Contracting State).

Finally, paragraph 7 of the Protocol specifies that the new DTT does not preclude the application of the French domestic provisions of Articles 115 quinquies, 123 bis, 155A, 209B, 212, 238A and 238-0 A of the French Tax Code.

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