New Double Tax Treaty between France and Luxembourg: impact on real estate structures

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In Brief

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

The new DTT seeks to modernise the rules applying. The current treaty between Luxembourg and France was signed as long ago as 1 April 1958. The new DTT is fully "post-BEPS". It implements the new approaches developed at international level during the OECD/G20 BEPS Project, 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"), signed by both Luxembourg and France in June 2017.

More particularly, several provisions of the DTT are likely to affect many French real estate investments held from Luxembourg, notably those involving French OPCIs. This flash news is based on the latest draft available at the date of its issuance and is mainly focused on provisions affecting real estate investments.

Details

Residency (Article 4 of the DTT)

The concept of "residency" for the purposes of applying the current DTT is not in line with that used in the OECD Model. The current DTT focuses on the concept of managed and controlled entity rather than the tax 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, in the light of recent case law by the French Administrative Supreme Court, being "subject to tax" requires being in effect being subject to tax without the possibility of an exemption that could be granted by another provision of local law. Tax exempt vehicles such as French OPCIs, SICAV Specialised Professional Funds ("SICAV FPS") or Luxembourg Specialised Investment Funds ("SICAV SIF") may thus not readily be considered in principle as "residents" in the meaning of the new DTT, although both texts in the accompanying Protocol (see below), and OECD work on treaty access for pension funds and investment funds should ease the position.

It should also be noted that the new DTT in its article 4.4 expressly mentions that French SCIs (subject to tax in France but for which investors are personally liable for taxes) are considered as "resident" in France in the meaning of this DTT.

Capital gains (Article 13 of the DTT)

Article 13 of the new DTT provides that generally capital gains are to be taxed only by the country where the person disposing of the asset (that gives rise to the gain) is a resident. Exceptionally, capital gains may be taxed in the country where the asset is located, notably in cases where the asset is:

- Immovable property situated in this other country; or
- Shares of a "real estate rich" company, i.e. a company deriving, directly or indirectly and at any time over the 350 days preceding the disposal, more than

50% of its asset value from immovable property situated in the other country. An exception is foreseen for disposals made in relation to companies that use the immovable property to carry on their own trading activities.

This latter provision is broadly consistent with the current DTT, which was only relatively recently amended (in September 2014) to add this "real estate rich" company measure. The new DTT however tightens the provision, extending its scope also to cover the situation during the 365 days before the disposal of the shares. The new DTT is consistent with the text of the MLI. Although at the time of signing the MLI France wished to have this part of the MLI apply to the fullest extent to all its treaties covered by the MLI, Luxembourg did not. Indeed, when signing the MLI, Luxembourg had opted to "reserve" against (and thus not to have to apply) any and all of the "real estate rich" company measures.

Dividends (Articles 10 and 22 of the DTT)

Under the current DTT, dividends paid by a company are subject to withholding tax at a maximum rate of 5%, so long as the recipient is a company resident in the other treaty country, and owning at least 25% of the share capital of the distributing company.

The new DTT improves and amends this rule to make it consistent with the MLI text, granting a full exemption of withholding tax for any holding by a corporate resident of at least 5%, providing it has been held for at least 365 days.

Also, under the current DTT, there is a specific and explicit "participation exemption" measure in the treaty text, for dividends received from holdings of 25% or more that qualify for the 5% maximum withholding rate. This special provision has not come forward into the new expected DTT.

Instead, in cases where a dividend is paid from France to Luxembourg, for example, it is foreseen that Luxembourg has the right to tax the income but should, in principle, grant a credit for French withholding tax against the Luxembourg liability on the dividend flow (even though the draft text refers to "deduction of French tax paid"). This new provision of course does not preclude the Luxembourg domestic tax regime (which, in the absence of specific measures taxes Luxembourg residents on their worldwide income) from granting exemptions from Luxembourg taxes. In many cases where the dividend recipient is a Luxembourg company, the normal (and broad) Luxembourg "participation exemption" may apply.

Finally, the very end definition of "dividend" has been modify and would now include distribution that local law assimilate to a dividend distribution. This should notably be the case of liquidation proceeds from French companies that may now suffer a withholding tax.

Holdings in French OPCIs or SIIC

One area in which the current DTT provisions have been of importance is in the context of dividends distributed to a Luxembourg company by an *organisme de placement collectif immobilier* ("OPCI") set up in the form of a *société de placement à prépondérance immobilière à capital variable* ("SPPICAV").

Subject to liquidity conditions, an OPCI established under the SPPICAV form is exempt from French corporate income tax.

Under the current DTT, where a Luxembourg company holds at least 25% of the capital of the French OPCI and receives a dividend from it, the Luxembourg company may suffer French withholding tax at the 5% treaty rate, and will be treaty-exempted from any further Luxembourg taxes.

This outcome will change markedly under the new DTT.

Under Article 10.6 a) of the new DTT, dividend distributions that derive from real estate-related income, and are made by any fund vehicle or company that distributes most of its exempt real estate income and gains on an annual basis, are expressly taxable in the recipient country. Because the Luxembourg domestic "participation exemption" regime does not in principle apply to holdings in French OPCIs or SIIC (French REIT) for their portion of exempt real estate income, this new DTT measure leaves distributions from French OPCIs or SIIC **fully subject to Luxembourg** corporate income **taxes**, but the Luxembourg entity should probably be in a position to claim a tax credit.

Furthermore, under the new DTT such dividend distributions will also be subject to much higher withholding taxes. Article 10.6 b) of the new DTT allows a 15% maximum withholding tax rate, but only where the beneficial owner of the dividends holds directly or indirectly less than 10% of the share capital in the fund vehicle.

When the beneficial owner of the dividends holds 10% or more of the share capital of the fund vehicle, under Article 10.6 c) of the new DTT, dividends are **not granted a reduced treaty rate of withholding tax**, and are thus subject to withholding tax at the relevant domestic

withholding rate (i.e. 30% in France, that should be reduced to 25% in 2022 – but potentially 15% in some specific cases).

Access to the treaty for UCIs (Paragraph 2 of the Protocol)

The Protocol grants access to DTT benefits to Undertakings for Collective Investments ("UCIs"), although under restrictions.

UCIs established in France or Luxembourg and assimilated (according to the law of the other treaty country), to UCIs in that other country will be entitled to the benefits of Article 10 (dividends) and Article 11 (interest) of the new DTT. However, this will only be the case for components of such dividends or interest that correspond to rights in the UCI owned by "equivalent beneficiary" investors. Investors are "equivalent beneficiaries" if they are residents of France or Luxembourg, or residents of countries that have signed (with the country that is the source of the relevant dividends or interest) a convention on mutual administrative assistance against tax evasion.

Entry into force (Article 30 of the DTT)

The tax treaty will enter into force once both parties complete the ratification process.

Treaty provisions will then be effective as follows.

In France

- For withholding taxes, for amounts taxable after the civil year during which the DTT entered into force.
- For income taxes not withheld at source, for civil years or tax years after the year of entry into force of the DTT.
- As respects other income, for taxes whose triggering event occurs after the civil year in which the DTT enters into force.

In Luxembourg

- For withholding taxes, for amounts taxable on or after 1 January of the civil year following that during which the DTT entered into force.
- For income taxes and net wealth tax, for tax years starting on or after the above 1 January.

Our view

The main provision of the new DTT as it affects real estate investment clearly targets a very typical form of investment, whereby a Luxembourg company holds most of the shares in a French OPCI/SPPICAV or a SIIC.

Under the provisions of the new DTT, dividends distributed by a French OPCI or SIIC to a normally taxed Luxembourg holding company will be subject to a 30% withholding tax (as opposed to 5% under the current DTT). Furthermore, on receipt, the dividend will be fully subject to Luxembourg corporate income taxes. The 30% withholding tax should only be partially creditable (e.g. not against municipal business taxes), and under specific conditions.

The direct holding of a French OPCI or SIIC by an appropriate form of Luxembourg UCI might be considered as a suitable alternative, in order potentially to mitigate this significant increase of the tax leakage.

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