New Double Tax Treaty between Luxembourg and France

22 March 2018

In brief

On 20 March 2018, the Luxembourg and French Governments signed a new double tax treaty (DTT) with France, together with an accompanying Protocol.

The new DTT seeks to modernise the treaty as a whole – 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, and now reflected in the 2017 version of the OECD Model Tax Convention ("the 2017 OECD Model"), and in the Multilateral Convention to Implement Tax Treaty Related Measures "the MLI", signed by both Luxembourg and France in June 2017.

More specifically, the DTT redefines what constitutes a permanent establishment for the purposes of the DTT, and introduces new rules for the taxation of cross-border payments such as dividends, interest and royalties. The Protocol clarifies the situation of cross-border workers, and grants limited access to the DTT to Undertakings for Collective Investments ("UCIs").

Assuming that both the Luxembourg and French Governments now complete without any major delay the necessary processes for ratification of the new DTT, the provisions of the new DTT could be applicable in many situations from as soon as 1 January 2019.

In detail

Form of the new DTT

The form and text of the new DTT mostly follow closely the wording of the 2017 OECD Model, and the MLI. All Articles in the new DTT correspond to the equivalent Articles in the 2017 OECD Model. The title and preamble mirror the "post-BEPS" wording of the 2017 OECD Model, emphasising that the purpose of the treaty includes the prevention of tax evasion and avoidance, and the targeting of treaty-shopping arrangements. In this context, the new DTT includes as its "Entitlement to Benefits" Article 28, the "Principal Purposes Test" ("PPT") wording effectively identical to that of Article 29.9 of the 2017 OECD Model.

However, as might be expected given the common border between the two countries, and the advanced development of financial services industries in both countries, the new DTT also contains a number of specific "non-Model" provisions.

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Residency (Article 4 of the DTT)

The concept of "residency" found in the current DTT pre-dates, and 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 however does follow the 2017 OECD Model, and defines a resident – and thus a person entitled to access treaty benefits – as a person "subject to tax".

The clause in this Article of the new DTT that deals with double residence situations concerning legal entities retains the pre-2017 OECD Model approach of looking to the "place of effective management" as the "tie-breaker". The 2017 OECD Model/MLI new approach, of leaving the "tie-breaker" to be decided by competent authorities, has not been followed: notably, both Luxembourg and France had opted to "reserve" against (and thus not to have to apply) the relevant article of the MLI that would have introduced the new approach.

The new DTT expressly confirms that that French SCIs and some other similar types of entities (each 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.

Conversely, and disappointingly, the new DTT does not follow the 2017 OECD Model in confirming explicitly that "recognised pension funds" are to be regarded as residents for DTT purposes.

In addition, for certain collective investment funds and pension funds, in the light of recent case law by the French Administrative Supreme Court, being "subject to tax" necessitates being in effect being subject to tax without the possibility of any exemption that could be granted by another provision of local law. Tax-exempt vehicles, such as French OPCIs and SICAV Specialised Professional Funds ("SICAV FPS"), or Luxembourg Specialised Investment Funds ("SICAV SIF") may thus not readily be considered as "residents" in the meaning of the new DTT, although the accompanying Protocol (see below) should still afford a certain measure of treaty access for some such entities.

Permanent establishments (Article 5 of the DTT)

The new DTT does not diverge from the long-standing principle that profits of an enterprise located in one country are taxable only in that country, except when the enterprise y carries out business activities in the other country through a permanent establishment situated there.

The definition of a permanent establishment under the new DTT is in line with recent OECD work, and notably the recommendations made by the OECD Action Plan 7 Final Report ("Preventing the Artificial Avoidance of Permanent Establishment Status") that have been carried through into the 2017 OECD Model, and the MLI.

In particular, "commissionaire" arrangements are expected to be regarded as permanent establishments of the "principal" enterprise, as are any other arrangements where a party acting in one country on behalf of an enterprise habitually plays the principal role leading to the conclusion of contracts in the name of the enterprise. In addition, a party that acts in a country exclusively or nearly so on behalf of a related party is not allowed to use the "independent agent" let-out from the definition of permanent establishment. The stricter "Option A" of the MLI text has been followed in provisions in the DTT that further restrict the scope of the "preparatory or auxiliary" activity let-outs from the definition of permanent establishment.

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 these measures that re-define the permanent establishment for DTT purposes.

Dividends (Article 10 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** from withholding tax for any **holding by a company** resident in the other treaty country of **at least 5%**, providing it has been held for at least **365 days**.

For **other holdings** that cannot qualify for the withholding tax exemption noted above, the treaty rate of withholding tax under the new DTT is **15%**, unchanged from the current DTT.

The final part of the wording that defines a "dividend" for DTT purposes has been modified. Under the new DTT, the definition includes any distribution that domestic law assimilates to a dividend distribution. This is notably the case for liquidation proceeds from French companies – these may thus suffer withholding tax under the new DTT. Conversely, Luxembourg law does not generally treat liquidation distributions being made as dividends being paid, and in such cases does not seek to apply any withholding tax under Luxembourg domestic law.

Holdings in French OPCIs or SIICs

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. The dividend is then (see comments below on Article 22) treaty-exempted from any further Luxembourg taxes.

This outcome will change markedly under the new DTT, which contains specific provisions concerning dividends paid out of profits generated from real estate assets.

Under Article 10.6 a) of the new DTT, dividend distributions, which derive from real estate-related income generated 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.

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 <u>any</u> reduced treaty rate of withholding tax. They are thus to be subject to withholding tax at the relevant domestic withholding rate (i.e. 30% in France, reducing to 25% by 2022 – but potentially 15% in some specific cases).

Because the Luxembourg domestic "participation exemption" regime does not in principle apply to holdings in French OPCIs or SIICs (French REITs), this new DTT measure has a significant effect, leaving distributions from French OPCIs or SIICs fully subject to Luxembourg corporate income taxes. However, under the new DTT a Luxembourg recipient of dividends, that is taxable on such income and that has suffered French withholding taxes as noted above, should often be in a position to claim a tax credit. See further comments below on Article 22.

Interest (Article 11 of the DTT)

Cross-border interest payments are to be taxable only in the country where the recipient is a resident. In other words, there is a **full exemption** from withholding tax. (It should of course be noted that Luxembourg domestic law anyway generally does not impose withholding tax on interest flows).

This full exemption represents a change from the equivalent provision in the current DTT, which allows withholding tax to be imposed, at a maximum 10% rate.

Consistent with the OECD Model, the Article however goes on to provide that this treaty relief is limited to the "arm's length" portion of the interest. In other words, in cases where an interest rate is considered to be excessive as a result of special relationships between the parties, the excess part of the interest (compared to the rate that would have been agreed in the absence of any special relationship) remains taxable in accordance with domestic law and other provisions of the new DTT.

Royalties (Article 12 of the DTT)

Cross-border royalty payments are to be taxable in the country where the recipient is a resident. Such royalties may also be taxed in the source country. However, the taxation is not to exceed **5%** of the gross amount of the royalties paid to the recipient. (Under Luxembourg domestic tax law, there is generally no withholding tax on royalty payments).

This 5% rate represents a change from the equivalent provision in the current DTT, which gives a full exemption from withholding tax.

In a manner similar to the anti-avoidance provision applicable to cross-border interest noted above, the new DTT provides that treaty relief is limited to the "arm's length" portion of the royalties.

Capital gains (Article 13 of the DTT)

Article 13 of the new DDT 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
- Movable property allocated to a permanent establishment in this other Contracting Party; or
- Shares of a "real estate rich" company, i.e. a company deriving, directly or indirectly and at any time over the 365 days preceding the disposal, more than 50% of its asset value from immovable property situated in the other country. (An exception is made for disposals made in relation to companies that use the immovable property to carry on their own trading activities).

This last provision is broadly consistent with the current DTT, which was only relatively recently amended to bring in this "real estate rich" company measure. (The relevant Protocol was signed in September 2014). The new DTT however tightens the provision, extending its scope also to cover the situation during the 365 days before the share disposal.

The new DTT is consistent with the text of the MLI concerning "real estate rich" companies. 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.

The new DTT introduces a further exception to the general rule that only the country where the owner of the asset is resident can tax a gain arising. This further rule goes beyond the 2017 Model and the

MLI, and concerns disposals by individuals of major shareholdings (e.g. in family-owned companies), in cases where the **individual** making the disposal has **migrated** from the country where the company is resident to the other treaty country within the **previous 5 years**. Under the new DTT, capital gains derived by an individual from the disposal of a substantial shareholding (where the shareholder is holding directly or indirectly, alone or together with connected persons, shares or similar instruments based on which the shareholder is entitled to **at least 25%** of the profits of a company) in a company located in the other country, are taxable in that other country.

Employment income and cross-border workers (Article 14 of the DTT, and paragraph 3 of the Protocol)

The article of the DTT concerning salaries has been completely overhauled, and is now based directly on the OECD Model Article 15 on employment income taxation.

As such, the right to tax employment income derived by a resident of one country from an activity exercised in the other country is taxable in that other country. For example, Luxembourg has the right to tax the salary income of French residents who work in Luxembourg.

However, the new DTT continues to include a frequently relevant exception, included in the OECD Model, dealing with shorter term secondments of staff and business trips. When the activity is exercised in a country other than the country of an individual's residence, the right to tax the income remains allocated to the country of residence, although only when the following cumulative conditions are met:

- The employee spends less than 183 days in the other country within any 12-month period; and
- The employee's compensation is paid by an employer (or on behalf of an employer) not located in the other country, and
- The burden of the compensation is not borne by a permanent establishment of the employer located in the other country.

An important "non-Model" measure concerning employees is set out in paragraph 3 of the Protocol to the new DTT, which introduces a derogation from the standard position. Income in connection with days spent "abroad" by a worker (either in the country of the individual's residence or in third countries, rather than at the usual place of work) remains taxable in the country where the usual place of work is located, provided that no more than **29 days** are spent "abroad" during the taxable period. With respect to days spent in third countries, this derogation applies without prejudice to any provisions of the DTT applicable between the country of residence and a third country in which the individual has spent some work days.

In practice, this means that a French tax resident working for a Luxembourg employer is taxable in Luxembourg on the entire amount of his or her employment income, provided that he or she does not work more than 29 days in a tax year outside Luxembourg. At the time of writing, no specific guidance has been given with a view to providing clarity on how this 29-day threshold should be computed.

Similar provisions already apply with respect to the DTTs concluded by Luxembourg with both Germany and Belgium. However, the threshold set in the new DTT with France is higher than those applying with Germany (maximum 19 days) and Belgium (maximum 24 days).

Pensions (Article 17 of the DTT)

In line with the current DTT's rules, the new DTT specifies that the right to tax pensions paid under social security legislation (the "first pension pillar") is given only to the source country.

As regards employer-provided pension plan benefits, the new DTT does not introduce any new provisions. Such benefits remain fully taxable in the country of residence of the recipient, but cannot also be taxed by the source country. Therefore, French tax resident individuals benefiting from a Luxembourg employer-provided pension plan will continue to suffer taxation in France upon receipt of the plan benefits. This is notwithstanding the fact that taxation has, in economic terms, already been levied at source in Luxembourg (20% flat tax payable by the employer at the time of contribution, calculated on employer's contributions to the pension plan).

Elimination of double taxation (Article 22 of the DTT)

French residents

The new DTT brings about a major change in the way French tax residents are granted relief from double taxation on income (other than dividends and interest) from Luxembourg. Under the current DTT such income of French tax residents is relieved from double tax using the "exemption with progression" method. Under this method, "foreign" (in this case, Luxembourg-source) income is tax-exempt, but is nevertheless taken into account in calculating the tax rate applicable to other income in the country of residence (in this case, France) that is taxable there.

However, under the new DTT, the tax "credit" method is to be applicable for all types of income. Under this method, tax is imposed on all sources of income by the country of residence (in this case, France), but the amount of tax that is payable in the country of residence is reduced based on the amount of tax already suffered in the "foreign" (in this case, Luxembourg) country, through the granting of a credit.

As well as income attributable to permanent establishments, the **new method applies** (notably) to **employment income** and director's fees.

For French resident individuals, including cross-border workers, this tax credit method will be likely to trigger many practical issues. For example, taxes may be levied in Luxembourg at different dates – first, a withholding tax may apply, then final taxation will be charged following the filing of a personal income tax return and the issuing of a tax assessment, which might only happen several years later.

Luxembourg residents

For Luxembourg tax residents (both individual and corporate) deriving French source income, the "exemption with progression" method remains applicable under the new DTT for **most** types of income (the "foreign" income is tax-exempt, but taken into account in calculating the tax rate applicable to Luxembourg taxable income). However, with respect to dividends, royalties, and the income of artistes or sportsmen, which under the new DTT may be taxed in France, the tax "credit" method applies. The tax credit is limited to an amount equivalent to the Luxembourg tax due on that same source of French income.

Also, under the current DTT, within the treaty text rules for eliminating double taxation there has been a specific and explicit "participation exemption" measure, for dividends received from holdings of 25% or more that qualify for the 5% maximum withholding rate. Hence Luxembourg companies receiving dividends from such holdings are currently protected by the DTT from suffering tax on such dividend income, even in cases where the Luxembourg domestic "participation exemption" regime does not result in such an exemption. This special DTT provision aimed at eliminating double taxation has not come forward into the new DTT.

Instead, in cases where a dividend is paid from France to Luxembourg, under the new DTT Luxembourg has the right to tax the income. Luxembourg's tax regime does, in the absence of specific reliefs and exceptions, tax Luxembourg residents on their worldwide income. Hence this change does represent a significant shift in the balance of taxing rights.

This new provision of course does not preclude the Luxembourg domestic tax regime from granting exemptions from Luxembourg taxes. In particular, in many cases where the dividend recipient is a Luxembourg company, the normal Luxembourg "participation exemption" would still apply.

If Luxembourg however does not exempt the income under its domestic regime, the new DTT should grant a credit for French withholding tax against the Luxembourg tax liability on the dividend flow (even though the new DTT text refers to a "deduction" of French tax paid).

Entitlement to tax treaty benefits (Article 28 of the DTT, and paragraph 7 of the Protocol)

In line with commitments made within the framework of the MLI (to which, as noted above, both Luxembourg and France are founding signatories), the DTT contains the "Principal Purposes Test" ("PPT"). The wording used in the new DTT is fully consistent with the 2017 OECD Model, and the MLI. A benefit under the DTT is not to be granted in respect of an item of income or capital, if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granted that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the DTT.

Paragraph 7 of the Protocol further gives the right to France to apply some of its domestic tax law provisions (articles 115*quinquies*, 123*bis*, 155 A, 209B, 212, 238 A and 238-0 A from the "Code general des impôts" or other similar provisions) in a way which over-rides all provisions of the new DTT.

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

The Protocol gives "undertakings for collective investment" ("UCIs") limited access to DTT benefits.

UCIs established in Luxembourg or France and assimilated, according to the law of the **other** country, to UCIs situated there, are to be entitled to the benefits of Article 10 (cross-border dividends) and Article 11 (cross-border interest).

This entitlement is however restricted by an "equivalent beneficiary" type of test. Treaty benefits are only applicable to the element of these types of income flow that corresponds to rights owned in the UCI by residents of either Luxembourg or France, or by 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.
- For other income, for when the triggering event for the tax 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.

Assuming that both the Luxembourg and French Governments now complete the ratification process without any major delay, the provisions applying under the new DTT could be applicable in many situations from as soon as 1 January 2019.

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