Ratification of the Double Tax Treaty between Luxembourg and Cyprus

26 March 2018

In brief

On 22 March 2018, the Luxembourg Parliament voted to approve Bill n° 7226 (the "Bill"), concerning the double tax treaty ("DTT") between Luxembourg and Cyprus signed in May 2017. Cyprus had been the last EU Member State with which Luxembourg had no DTT in force.

Assuming that the exchange of the instruments of ratification between Luxembourg and Cyprus takes place during 2018, the DTT should enter into force on 1 January 2019.

Through the extension of its tax treaty network, Luxembourg continues to show its willingness to be a key international partner of the world's economies.

In detail

Article 4: Residency

The DTT follows the OECD Model Convention (the "OECD Model") and defines a resident – and thus a person entitled to access treaty benefits – as a person who, under the law of the country concerned, is liable to tax there by reason of their domicile, residence, place of management or any other criterion of similar nature. The clause dealing 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".

A Protocol accompanying the DTT confirms that a Collective Investment Vehicle ("CIV") is to be considered both as "resident" under the DTT and the beneficial owner of the income it receives. This is the case both for CIVs that are liable to tax, and for CIVs that are exempt from tax purely because they met the conditions of domestic legislation granting tax exemptions to CIVs.

Article 10: Withholding tax on dividends

Cross-border dividends payments (i.e. dividends arising in one country and distributed to a resident of the other country) are to be subject to **0%** withholding tax if the beneficial owner is a **company** (other than a partnership) which holds directly **at least 10%** of the capital of the company paying the dividends.

In all other cases, dividends payments are to be subject to a **5%** withholding tax.

Article 11: Withholding tax on interest

Cross-border interest payments are generally to be taxable only in the country of the recipient of the income – in other words subject to **0%** withholding tax. This provision is however "subject to the legal acts of the European Union". It could thus in theory be disapplied if, for example, the interest flow was caught by an anti-avoidance rule in the EU Interest and Royalties Directive. How this could currently arise in practice is unclear – as matters stand neither Luxembourg nor Cyprus domestic legislation imposes any withholding tax on interest flows to non-residents.

Article 12: Withholding tax on royalties

Cross-border royalty payments are generally to be taxable only in the country of the recipient of the income – in other words subject to **0%** withholding tax.

Article 13: Capital gains

Generally, capital gains are to be taxed only by the country where the person disposing of the asset (which 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 country; or
- Shares in a "real estate rich" company, i.e. a company deriving directly more than 50% of its asset value from immovable property situated in the other country.

Article 20: Offshores activities

The DTT provides for a specific article dealing with offshore activities. This provision relates to the deemed constitution of a permanent establishment where a resident of one Contracting State carries on offshore activities in connection with the exploration or exploitation of the seabed or subsoil or their natural resources situated in the other Contracting State, if such activities are carried on for a period exceeding 30 days in the aggregate in any twelve month period commencing or ending in the fiscal year concerned.

The DTT also provides for a specific clause related to salaries, wages and similar remuneration derived by a resident of a Contracting State in respect of an employment connected to such offshore activities.

Article 23: Elimination of double taxation

Luxembourg has opted for a combination of the "exemption with progression" method and the "credit" method to eliminate double taxation, depending on the type of income concerned, as follows:

- Luxembourg applies the "credit" method to flows of dividends, irrespective of the size of the shareholding or the nature of the owner (providing the holding is not effectively connected to a permanent establishment of the owner in Cyprus), and to the earnings of artistes and sportsmen. Under the DTT, Luxembourg retains taxing rights over such income flows, but must grant a credit (the DTT text in fact refers to a "deduction") for Cypriot taxes. The tax credit is limited to an amount equivalent to the Luxembourg tax due on that same source of Cypriot income. It should be noted that this rule does not require Luxembourg to tax the income – for example if the dividend from Cyprus can benefit from the "participation exemption" under Luxembourg domestic legislation, then the DTT will not over-ride this exemption.
- For any other source of income, Luxembourg is to exempt the income "with progression" (i.e. the Cypriot-source income is tax-exempt, but must be taken into account in calculating the tax rate applicable to other Luxembourg taxable income).

- The DTT however contains a specific rule to counter "double non-taxation", using the wording of Art 23A (4) of the OECD Model.

Cyprus has opted for the "credit" method generally to eliminate double taxation. However, if the DTT exempts a Cypriot resident from Cypriot tax on a source of income, this exemption will then be "with progression".

Article 28: Entitlement to benefits

Both Luxembourg and Cyprus were founding signatories, in June 2017, to the OECD Multilateral Convention to Implement Tax Treaty Related Measures (the "MLI"). In line with commitments made within the framework of the MLI, the DTT contains a "Principal Purposes Test" ("PPT") clause. The wording used in the DTT is fully consistent with the 2017 OECD Model, and the MLI.

Under the PPT, a benefit under the DTT shall not be granted in respect to 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 granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the DTT.

This Article contains a clause, consistent with the text of the MLI, which allows a taxpayer, otherwise caught by the PPT, to request the "competent authority" within the tax authority of the country of residence to grant discretionary relief, and instead allow a treaty benefit to be retained.

In conclusion

Further to the 22 March vote approving the Bill, effectively the treaty has now been ratified by Luxembourg. The DTT will enter into force on the date of completion of the exchange of ratification instruments between Luxembourg and Cyprus.

Subject to the completion of these steps during the remaining part of 2018, the DTT will be applicable as follows:

- For taxes withheld at source, to income derived on or after 1 January 2019;

- For other taxes on income and on capital, for taxes chargeable for any taxable year beginning on or after 1 January 2019.

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