NEW TAX TREATY BETWEEN FRANCE AND LUXEMBOURG: FRENCH TAX IMPLICATIONS FOR INVESTORS

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INTRODUCTION

France and Luxembourg signed a new double tax treaty on income and capital (the "New D.T.T.") on March 20, 2018. The New D.T.T. is awaiting ratification by the parliaments of both countries, which is expected to occur this year. If the target date for ratification is met, some provisions will enter into force as of January 1, 2019.

The New D.T.T. comes 60 years after the passage of the current double tax treaty on income and capital (the "Current D.T.T."), which was signed on April 1, 1958, and has been amended four times since it entered into force, in 1970, 2006, 2009, and 2014.

One significant change resulting from the New D.T.T. is the increase in the withholding tax rate on distributions made by certain French real estate investment vehicles from 5% to a potential 30%. These structures are currently heavily used by institutional real estate investors. It is likely that the real estate industry will be busy this year, searching for ways to cope with the increased tax burden.

Many of the provisions of the New D.T.T. are modeled after the O.E.C.D. Model Tax Convention (the "O.E.C.D. Model"). However, due to the trade history between France and Luxembourg, there are notable departures. Interestingly, several provisions of the New D.T.T. are directly inspired by the Multilateral Instrument ("M.L.I."), even though Luxembourg reserves the right to exclude some of these provisions in its Covered Tax Agreements, which include double tax treaties already in force and therefore encompass povisions that are now part of the New D.T.T.

RESIDENCY – ARTICLE 4 OF THE NEW D.T.T.

In accordance with the latest 2017 version of the O.E.C.D. Model, the New D.T.T. defines the term "resident" as "a person who is liable to tax."

In addition to the provisions found in the O.E.C.D. Model, the New D.T.T. addresses *sociétés de personnes* (French partnerships), *groupements de personnes* (groups of individuals), and similar entities that can be deemed resident if

- the place of effective management is situated in France,
- they are liable to tax in France, and
- the shareholders, partners, or members, are all personally subject to tax in France on their respective portions of profits.

The New D.T.T. adds that a trustee or fiduciary, as such, is not considered a resident of a contracting state even if he or she were to qualify as a resident of one of the

contracting states under the general definition. This applies when and to the extent that he or she is only the apparent beneficiary of the income so that another person who cannot be deemed a resident of that particular contracting state receives the benefit.

Collective Investment Vehicles ("C.I.V.'s") established in France or Luxembourg, which are generally tax-exempt, should a priori not be treated as residents under the New D.T.T., because the liable-to-tax test cannot be met by the C.I.V. However, Paragraph 2 of the accompanying Protocol to the New D.T.T. (the "Protocol") provides that C.I.V.'s that are established in one contracting state and are comparable to domestic C.I.V.'s under the law of the other state may receive the benefit of the dividends and interest provisions (Articles 10 and 11) of the New D.T.T. These benefits apply to the fraction of C.I.V. income corresponding to the rights of persons who reside in one of the contracting states or a state that has a treaty of administrative assistance for the purpose of preventing tax evasion and avoidance with the source contracting state.

In sum, the addition of residency provisions is a major novelty of the New D.T.T., as the Current D.T.T. contains only a very short and old definition of "tax domicile" and not "residence."

PERMANENT ESTABLISHMENT – ARTICLE 5 OF THE NEW D.T.T.

The New D.T.T.'s permanent establishment definition closely follows the O.E.C.D. Model and incorporates elements contained in the Current D.T.T.

A notable departure from the Current D.T.T. relates to *commissionaire* arrangements. Under the New D.T.T., *commissionaire* arrangements may be deemed a permanent establishment when, *inter alia*, the party is acting in one "Contracting State on behalf of an enterprise and, in so doing, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise." The New D.T.T. foresees that when a person acts exclusively or almost exclusively on behalf of one or more closely-related enterprises, that person will not be allowed to use the independent-agent exemption to a permanent establishment.[1]

The New D.T.T. also incorporates Option B under Article 13(3) of the M.L.I. with respect to permanent establishment exemptions for specified activities. It provides that the maintenance of a fixed place of business solely for the purpose of carrying on activites of a "preparatory or auxiliary character" is generally not deemed to be a permanent establishment. The New D.T.T. also adds an anti-fragmentation provision for the case of activities between closely-related parties.[2]

Permanent establishments are also addressed under the business profits provision (Article 8) of the New D.T.T. This provision follows the long-standing principle that the profits of an enterprise located in one contracting state are taxable only in that contracting state, except when the enterprise carries on business in the other contracting state through a permanent establishment situated therein. This is a more

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1 These provisions are modeled after Article 12 of the M.L.I.

2 Article 13(4) of the M.L.I.

modern wording than the Current D.T.T., which states that under specific rules, business profits are only taxable in the country in which the permanent establishment is situated.

DIVIDENDS – ARTICLE 10 OF THE NEW D.T.T.

New Withholding Taxes

Although the principle that provides "the right to tax a dividend belongs to the country of the recipient of the dividend" remains, both the New D.T.T. and the Current D.T.T. grant a general withholding tax rate of 15% to the source country.

The domestic French withholding tax rate is 12.8% for dividends distributed to individuals and 30% for those distributed to companies (subject to exceptions). In the latter case, for financial years beginning on or after January 1, 2020, the withholding tax rate will equal the normal corporate income tax rate. The marginal corporate tax rate is due to be reduced gradually, from the current rate of 33 1/3% to: 31.0% as of 2019, 28.0% as of 2020, 26.5% as of 2021, and 25.0% as of 2022.

Under the Current D.T.T., there is a preferential withholding tax rate of 5% on dividends. This rate generally applies where the beneficial owner holds a substantial participation of at least 25% of the capital of a distributing company. The New D.T.T. improves upon this preferential regime. Consistent with Article 8 of the M.L.I., the New D.T.T. provides a full exemption from withholding tax on dividends paid by a company of one treaty country to a company resident in the other treaty country that holds at least 5% of the capital of the distributing company throughout a 365-day period from the date of dividend payment. No account is taken of changes of ownership that directly result from a corporate reorganization, such as a merger or divisive reorganization, of the shareholder company or the company paying dividends.

French domestic law allows for a similar exemption of withholding tax. The benefit applies if, among other conditions, the Luxembourg parent holds at least a 10% shareholding in the French subsidiary or at least a 5% shareholding if it cannot impute the French withholding tax.

Distributions from Real Estate Investment Vehicles

A novelty of the New D.T.T. and its practical repercussions for Franco-Luxembourg business relations is the addition of a new provision concerning distributions from real estate investment vehicles.

Under the new provision, when the majority of tax-exempt dividends derived from real estate income or gains are paid out on a yearly basis by an investment vehicle in one contracting state to a resident of the other contracting state, they are taxable in that other state. However, the dividends can be taxed in the source country, but the withholding tax rate is dependent on the following:

- If the beneficial owner either directly or indirectly holds less than 10% of the distributing vehicle then a 15% withholding tax rate under the treaty can be applied.
- If the beneficial owner either directly or indirectly holds 10% or more of the distributing vehicle, the dividends are taxed up to the domestic withholding tax rate, rather than at a beneficial treaty rate.

This treatment is a significant change to the current market practice. Several French real estate investment structures are organized to allow a Luxembourg vehicle to hold an interest in French (i) *organismes de placement collectif en immobilier* (undertakings for collective investments in real estate or "O.P.C.I.'s") structured as *sociétés de placement à prépondérance immobilière à capital variable* (real estate investment companies with variable capital or "S.P.P.I.C.A.V.'s") or (ii) s*ociétés d'investissement immobilier cotées* (real estate investment trusts or "S.I.I.C.'s"), the latter being listed investment vehicles. Both the S.P.P.I.C.A.V.'s and S.I.I.C.'s are exempt from corporate income tax in France unless otherwise specified.

"Royalty payments are taxable in the country where the recipient is a resident, and the source country may apply a general withholding tax rate of 5%."

As a result, French real estate investment vehicles distributing dividends to Luxembourg vehicles with a 10% or greater interest could be subject to French withholding tax of up to 30% – as opposed to the 5% treaty rate under the Current D.T.T. for dividends distributed to a 25% or greater owner, which, under certain conditions, were not subject to tax in Luxembourg. This is dicussed in the commentary on Article 22, below.

Fortunately, French domestic law may provide a saving grace in this respect. The withholding tax rate may be reduced to 15% if distributions are made from S.P.P.I.C.A.V.'s and S.I.I.C.'s to certain Luxembourg C.I.V.'s. However, for S.I.I.C.'s, a 20% domestic levy could also apply when, subject to certain conditions, distributions are made to a 10% or greater tax-exempt investor that is not an individual.

In addition, because a S.I.I.C. is not necessarily categorized legally as an O.P.C.I. (*i.e.*, a form of C.I.V.), the question arises as to whether a tax-exempt S.I.I.C. can receive the benefit of Article 10 of the New D.T.T. in accordance with Paragraph 2 of the Protocol. This can be compared to the current treaty between France and the United States, which expressly grants treaty-resident status to both S.I.I.C.'s and S.P.P.I.C.A.V.'s. Further commentary is needed to better assess the question.

INTEREST AND ROYALTIES – ARTICLES 11 AND 12 OF THE NEW D.T.T.

The New D.T.T. stipulates that interest is taxable in the country where the recipient is a resident and will no longer allow the imposition of withholding tax on interest income. This is preferable to the treatment under the Current D.T.T., which calls for a general treaty withholding tax rate of 10%. This change has little impact from a French perspective, as interest payments are in principle not subject to withholding taxes when paid to Luxembourg residents.

Under the New D.T.T., royalty payments are taxable in the country where the recipient is a resident, and the source country may apply a general withholding tax rate of 5%. This is a new condition when compared to the Current D.T.T., which does not provide the source country with a general treaty withholding rate.

Generally, French domestic law applies a withholding tax on royalties equal to the corporate income tax rate, currently 33 1/3%, which is set to be reduced gradually to 25% by 2022. Under certain conditions, an exemption may apply, such as when the Luxembourg recipient is a 25% or greater shareholder.

CAPITAL GAINS – ARTICLE 13 OF THE NEW D.T.T.

The capital gains article of the New D.T.T. is similar to the O.E.C.D. Model in that

capital gains are generally taxed by the country where the person disposing of the assets is a resident. In contrast, the Current D.T.T. does not have a standalone capital gains clause. This section provides commentary on the most important capital gains taxable in the source country under the New D.T.T.

Capital Gains Derived from Interests in Real Estate

The New D.T.T. stipulates that a gain derived from the alienation of immovable property is taxable in the country where it is situated. This is similar to the treatment under the Current D.T.T.

The New D.T.T. further provides that gains derived by a resident of a contracting state from the alienation of shares or other participations in a company, trust, or other institution or entity, may be taxed in the other contracting state if, at any time during the preceding 365 days, these shares or comparable interests directly or indirectly derived more than 50% of their value from immovable property in that other contracting state. Immovable property used to carry on one's own trade activities is excluded. In this respect, the New D.T.T. merely modifies the Current D.T.T. by extending its scope to include a 365-days look-back period.

In general, the French withholding tax rate levied on occasional capital gains realized upon the sale of real estate can be either 19% or the applicable corporate income tax rate, subject to specific conditions. Occasional gains on the disposition of shares in a S.P.P.I.C.A.V. or S.I.I.C. are subject to French domestic withholding taxes if the nonresident investor has a shareholding of at least 10%. Additional social security charges and taxes may apply depending on the situation. For habitual gains, withholding tax is the corporate income tax. As a reminder, the corporate income tax rate will be gradually reduced from 33 1/3% to 25.0% by 2022.

Substantial Participation Clause for Individuals

The New D.T.T. provides that capital gains realized by an individual resident in one contracting state on the sale of shares of an entity that is a resident of the other contracting state are taxable in that other contracting state if he or she directly or indirectly holds, either alone or with related persons, at least 25% of the rights to the profits of such entity. This rule applies only if the individual was a resident of the other contracting state in which the entity is a resident of at any time during the five years preceding the disposition of the participation. Such a rule is not included in the Current D.T.T. and goes beyond the scope of the capital gains clause found in the O.E.C.D. Model.

In general and excluding gains derived from real estate interests and any French exit tax implications, the French withholding tax could be 12.8% for individuals in such situations.

TAXATION OF CAPITAL – ARTICLE 21 OF THE NEW D.T.T.

The New D.T.T. follows the O.E.C.D. Model in that capital owned by a resident of a contracting state and situated in the other contracting state is taxed in that other state. The Current D.T.T. also has a similar result.

This provision would allow France to subject Luxembourg residents to the new

French tax on real estate wealth known as the *impôt sur la fortune immobilière* ("I.F.I."). The aforementioned provision of the New D.T.T. seems to exclude indirect holdings through companies when not deemed constituting real estate under French law. However, further commentary is needed to confirm this position.

ELIMINATION OF TAXATION – ARTICLE 22 OF THE NEW D.T.T.

For French Tax Residents

The New D.T.T. employs a tax credit method, where the Current D.T.T. relied on the exemption with progression method with a few exemptions (*i.e.*, for partnership income, dividends, and interest). Consequently, the New D.T.T. provides that:

- Income or capital that is taxable in Luxembourg remains taxable in France, and double taxation is eliminated via a tax credit equal to the amount of tax paid in Luxembourg, but which cannot exceed the amount of French tax owed.
- Income or capital that is only taxable in Luxembourg remains taxable in France, and double taxation is eliminated via a tax credit equal to the amount of French tax owed. However, if the French tax resident is not effectively subject to tax in Luxembourg, he or she cannot be granted the benefit of the French tax credit.

For Luxembourg Tax Residents

Under the New D.T.T., Luxembourg keeps a general application of the exemption with progression method when the income or capital is taxable in France, provided the amount is neither tax exempt in France nor subject to withholding tax under the treaty.

For dividends, royalties, and income from artistes and athletes, a tax credit is granted for the amount of French tax paid. This amount is limited to the Luxembourg tax owed. This is a change from the Current D.T.T., which does not tax French-source dividends if the Luxembourg company holds at least 25% of the share capital of a French company.

LIMITATION ON TREATY BENEFITS – ARTICLE 28 OF THE NEW D.T.T. AND PARAGRAPH 7 OF THE PROTOCOL

The New D.T.T. contains new limitation on benefits provisions in accordance with Article 7(1) of the M.L.I. Under the limitation, the benefits of the New D.T.T. will not be granted with respect to an item of income or capital if it is reasonable to conclude, considering all relevant facts and circumstances, that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in the creation of that benefit. This limitation stands 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 New D.T.T.

In addition, Paragraph 7 of the Protocol provides that the following French tax code (Code générale des impôts or "CGI") provisions will not be barred by the provisions of the New D.T.T.: (i) Article 115 quinquies (Branch Tax), (ii) Article 123 *bis* (Individual Tax Residents With Holdings in Certain Offshore Investments), (iii) Article 155 A (Remunerations Paid Abroad), (iv) Article 209 B (C.F.C. Rules), (v) Article 212 (Intragroup Interest Deduction Rules), (vi) Article 238 A (Limitations on Deductions for Payments Made to Low Tax Jurisdictions), (vii) Article 238-0 A (Noncooperative States or Territories).

ENTRY INTO FORCE – ARTICLE 30 OF THE NEW D.T.T.

The New D.T.T. will enter into force once both countries complete the ratification process and notify each other of its completion.

For France, the provisions of the New D.T.T. will apply as follows:

- For income taxes levied through withholding taxes, the provisions apply to taxable amounts after the calendar year in which the New D.T.T. enters into force.
- For income taxes not levied through withholding taxes, the provisions apply to all the income of a calendar year or fiscal year that start after the calendar year in which the New D.T.T. enters into force.
- For the other taxes, the provisions apply to taxable events that occur after the calendar year in which the New D.T.T. enters into force.

"Some provisions of the New D.T.T. could apply as early as January 1, 2019."

For Luxembourg, the provisions of the New D.T.T. apply as follows:

- For withholding taxes, the provisions apply to income attributed on or after the January 1 immediately following the calendar year in which the New D.T.T. enters into force.
- For the other taxes, the provisions apply to any tax due for an entire taxable year starting on or after the January 1 immediately following the calendar year in which the New D.T.T. enters into force.

Should the ratification process be completed in 2018, which is likely, some provisions of the New D.T.T. could apply as early as January 1, 2019.

CONCLUSION

Several issues exist for businesses and the financial services sector:

- The New D.T.T. provides no transitional relief allowing the business and financial sectors time to revise structures.
- The new dividend treatment of French real estate vehicles increases the tax cost of current real estate investment structures.

As a result, the Luxembourg financial services sector will need to act quickly to revise structures commonly used to invest in French real estate.

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