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Luxembourg Tax Alert

New tax treaty signed with France

23 March 2018

On 20 March 2018, the governments of Luxembourg and France signed a new double tax treaty and its additional protocol (hereinafter together referred to as "the new DTT") to replace the 60-year-old agreement between the two countries. The text of the new DTT is currently only available in French.

As explained by the Luxembourg Ministry of Finance a few days before, the new DTT has been completely reshaped compared to its previous version, with the aim to include provisions that reflect the latest OECD standards (2017 OECD Model Tax Convention).

The most significant features of the new DTT are the persons covered, the definition of permanent establishment, the withholding tax rate on dividends paid by real estate investment funds, the taxation of employment income, and the method to be used by France to eliminate double taxation (i.e., the credit method).

In light of the clause regulating the entry into force, the provisions of the treaty would become applicable at the earliest on 1 January 2019 (depending on the time required for its ratification by both countries), otherwise probably on 1 January 2020.

It has to be highlighted that multiple provisions of the new DTT would be subject to practical conditions, which have not yet been detailed in its current version. According to the new DTT, these conditions can be determined either together or separately by the contracting parties. We hope these practical conditions would be published either before or soon after the entry into force of this treaty and that the necessary guidance and clarification would be prepared together by both countries. Time will show how the new DTT would work in practice.

An overview of the main features of the new treaty is provided below.

Persons covered

The new DTT would apply to persons who are residents of one or both of the contracting states. Its definition of a resident is mainly in line with the OECD Model Tax Convention. However, it would expressly preclude trustees and fiduciaries from the benefits of the treaty, due to the fact they are not the beneficial owners of the income concerned by its provisions.

Its scope of application would also include income derived by or through entities, as specified in the new DTT, treated as wholly or partly fiscally transparent under the tax law of either contracting state, which would be considered to be income of a resident of a contracting state, but only to the extent that the income is treated, for purposes of taxation by that state, as the income of a resident of that state. The access to the new DTT would also be granted, under specific conditions, where these entities are established in a third country.

It is also foreseen that a collective investment fund of one contracting state assimilated to funds of the other contracting state could benefit from the provisions of the new DTT regarding dividends and interest in respect to the amount of revenues corresponding to the rights held by residents of one of the contracting states or by residents of any third country which signed an administrative assistance agreement against tax fraud and tax evasion with the country of source of the revenue.

Employment income

The provision regarding employment income has been completely reshaped and fully aligned with the OECD Model Tax Convention, which is in line with the double taxation rules, as provided in most of the double tax treaties signed by Luxembourg. As such, employment income is taxable in the country where professional activities are performed, with an exception for the commonly known 183 days rule, which returns the taxation right to the residence state if three conditions are met simultaneously.

In addition, the new DTT provides a tolerance rule that would apply to the cross-border workers once the new DTT would become applicable.

To give an example, based on this rule, French tax residents working in Luxembourg for Luxembourg employers would remain taxable in Luxembourg on their total employment income, provided their working days outside of Luxembourg would not exceed the total of 29 days per year. The same would apply to Luxembourg residents working in France for French employers.

By including the 29 days rule, the French and Luxembourg governments have considered the specifics of cross-border workers' reality. As an example, many French tax residents working in Luxembourg for their Luxembourg employers conduct business trips abroad and/or occasionally work from home. The 29 days rule would give them some flexibility to work abroad while remaining taxable in Luxembourg. Moreover, these provisions would also be mostly aligned with the similar clauses in the mutual agreements signed by Luxembourg with Belgium (24 days) and Germany (19 days).

As the new DTT does not provide any guidelines in terms of calculating the 29 days, we are awaiting further practical details (e.g., how half-days and sickness days should be treated, etc.). An approach established jointly by the tax authorities of the two countries would be most welcome in this respect.

Pension income

According to the new DTT, a 1st pillar pension income (i.e., legal pension paid by the Luxembourg/French Government) would remain taxable in the state that pays the pension.

All other pension income (i.e. 2nd and 3rd pillar) would remain taxable in the state of residence of the recipient.

This provision would imply that any payment made or any benefit received by a French resident in relation to a Luxembourg complementary pension would remain taxable in France. As a result, double taxation would continue to exist under the new DTT, as the contributions paid by the Luxembourg employer under such a scheme would be taxed at entry in Luxembourg and payouts would be taxed at exit in France.

The new DTT has not been aligned with the Luxembourg-Germany and Luxembourg-Belgium tax treaties in terms of the Luxembourg employer complementary pension contributions. Based on these double tax treaties, the right to tax these payouts is allocated to Luxembourg, where they are exempt.

Elimination of double taxation

For French tax residents, the new DTT would change the way double taxation is avoided, by moving from an exemption method with progression to a tax credit method.

This method would imply that as a first step, France would calculate the French taxes due on the taxable income, and as a second step, it would provide a tax credit, i.e., a deduction from the amount of French taxes, for the Luxembourg taxes already paid on the Luxembourg source income. The tax credit could not exceed the amount of French taxes calculated/payable.

The tax credit method would apply to all types of income, such as employment income, pension income, investment income, and real estate income. This method would be less favorable in principle than the exemption method, as in the end an individual would always pay the higher of both countries' tax rates.

Therefore, the new DTT may have an impact on the effective tax charge on Luxembourg employment income in the hands of French tax residents. However, this potential impact would depend on the way in which France would determine the calculation of the tax credit.

For Luxembourg tax residents, there would be no change and foreign employment income would continue being exempt with progression reserve. For other types of income (e.g., investment income), Luxembourg would continue to apply the tax credit method.

We are still awaiting further clarifications in terms of these practical aspects.

Permanent establishment

The definition of permanent establishment determines the threshold at which a taxable presence of an enterprise will arise in the other country. This definition has recently been subject to changes both under the Multilateral Convention to Implement Tax Treaty-related Measures to Prevent Base Erosion and Profit Shifting (hereinafter referred to as "MLI") and the OECD Model Tax Convention.

When signing the MLI, Luxembourg decided to opt for some provisions modifying the permanent establishment definition. The new DTT would include more modifications and seems follow the French position taken under the MLI, as well as the proposed wording of the OECD Model Tax Convention.

In practice, the new DTT would revise the definition of a permanent establishment by lowering the threshold at which a taxable presence of an enterprise will arise in the other country by:

Broadening the scope of the definition of a dependent agent;

Narrowing the exemptions for a fixed place of business by requiring activities to be of a “preparatory or auxiliary” character and by introducing an anti-fragmentation rule;

Aggregating time periods in the presence of a building site or construction or installation project.

Dividends, interest, and royalties

Dividend payments, as defined in the new DTT, would be taxable in the state of residence of their recipient, but would also be subject to withholding tax at source at a maximum rate of 15 percent.

The new DTT aims to reduce the level of participation required to benefit from the withholding tax exemption on dividend distributions between companies. Under the current treaty, to qualify for the exemption, the recipient has to hold at least 25 percent of the capital of the company paying the dividends. The new DTT decreases this participation requirement to only 5 percent, but at the same time introduces the additional condition of the holding period of 365 days. Therefore, if the recipient company would hold at least 5 percent of the capital of the company paying the dividends for a minimum of 365 days, and would be the beneficial owner of these payments, dividends would be taxable only in his state of residence. In case the exemption would not be applicable, the withholding tax could not exceed 15 percent, as long as the recipient of the dividends would remain their beneficial owner.

The new DTT would modify the withholding tax rate on dividends paid by real estate investment funds, as defined in this convention. It would amount to 15 percent when the beneficial owner would hold directly or indirectly less than 10 percent of the capital of the vehicle. However, for higher participations, the dividends would be taxable at a percentage established by the national law of the country of source.

Interest, as defined in the new DTT, would be taxable only in the state of residence of the recipient, free from withholding tax, provided the recipient would be their beneficial owner.

Royalties, as defined in the new DTT, arising in a contracting state and paid to a resident of the other contracting state may be taxed in that other state. They also may be taxed in the source state at a rate up to 5 percent of the gross amount (instead of no withholding tax on royalties under the current tax treaty).

Anti-abuse rules

Various anti-abuse rules would be included into the new tax treaty. Some of them, such as the preamble wording, as well as the principal purpose test, would be in line with the OECD requirements in connection with the MLI.

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Another of these provisions would allow France to apply some of its internal anti-abuse rules to transactions in scope of the treaty, meaning that the provisions of the convention would not preclude the application of internal rules.

In addition to the fact that the right to tax real estate investments (including real estate companies) remains in the state where real estate is located, a new rule would be added. It would allow for taxation of the sale by an individual resident in one contracting state of a substantial participation (25 percent or more) in a company established in the other contracting state, provided that this individual was resident in this other contracting state at any time during the 5 years preceding the alienation of these shares. Similar provisions have already been included into some of the double tax treaties signed by Luxembourg (i.e., the double tax treaty with Sweden).

Entry into force

The provisions of the currently existing treaty would no longer apply when the new treaty enters into effect. The new treaty and protocol would enter into force once the two countries mutually exchange their respective ratification instruments (following their respective ratification procedures).

In light of the clause regulating the entry into force, the treaty provisions would enter into effect as from 1 January of the calendar year following its entry into force. In practice, the provisions of the treaty would become applicable at the earliest on 1 January 2019 and otherwise, probably on 1 January 2020.

It also should be noted that some of the provisions chosen by France and/or Luxembourg under the MLI, such as the mandatory arbitration, have not been introduced into this treaty. Therefore, it can be expected that the two countries would opt for the application of the MLI to this convention, therefore introducing these MLI provisions into the content of the new DTT.

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