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Luxembourg launches the ratification of the new UK-Luxembourg Double Tax Treaty

OUR INSIGHTS AT A GLANCE

- On 24 February 2023, the draft law approving the new double tax treaty between the UK and Luxembourg was presented to the Luxembourg Parliament.
- The new DTT and an additional Protocol will replace the Double Tax Treaty signed in 1967. The aim of the new DTT is for the UK and Luxembourg to have a tax treaty that reflects the latest OECD tax standards. Some of these had already been taken into account through the modifications introduced by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. However, the new DTT goes significantly further and the main change is in relation to the taxation of Luxembourg entities with real estate investments in the UK.
- Now that the UK has already ratified the new DTT and Luxembourg launched its ratification procedure, it can be expected that the new DTT will enter into force over the course of this year so that the new provisions should become applicable as from 2024.

On 24 February 2023, the draft law approving the new double tax treaty ("**DTT**") between the UK and Luxembourg was presented to the Luxembourg Parliament.

The new DTT and an additional Protocol will replace the Double Tax Treaty signed in 1967 (the "**old tax treaty**"). The aim of the signature of the new DTT is for the UK and Luxembourg to have a tax treaty that reflects the latest OECD tax standards. Some of these had already been taken into account through the modifications introduced by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("**Multilateral Instrument**" or "**MLI**"). However, the new DTT goes significantly further.

As expected, the main change introduced in the new DTT is in relation to the taxation of Luxembourg entities with real estate investments in the UK.

We provide an overview of the most important changes to be introduced by the DTT for corporate taxpayers.

Tax residence

*DTT benefits granted to Collective Investment Vehicles ("**CIVs**")*

In contrast to the old tax treaty, the new DTT grants Luxembourg CIVs treaty benefits under the following conditions (based on Article 2 of the Protocol to the DTT):

- A CIV which is established and treated as a body corporate for tax purposes in Luxembourg and which receives income arising in the UK shall be treated as an individual who is a resident of Luxembourg and as the beneficial owner of the income it receives (provided that a resident of Luxembourg receiving the income in the same circumstances would have been considered as the beneficial owner thereof), but only to the extent that the beneficial interests in the CIV are owned by equivalent beneficiaries.
- However, if at least 75% of the beneficial interests in the CIV are owned by equivalent beneficiaries, or if the CIV is an undertaking for collective investment in transferable securities ("**UCITS**"), the CIV shall be treated as a resident of Luxembourg and as the beneficial owner of all of the income it receives (provided that a resident of Luxembourg receiving the income in the same circumstances would have been considered as the beneficial owner thereof).

"Equivalent beneficiary" means a resident of Luxembourg and, importantly, a resident of any other jurisdiction with which the UK has arrangements that provide for effective and comprehensive information exchange, who would, if he received the particular item of income for which benefits are being claimed under this DTT, be entitled under an income tax convention with the UK, to a rate of tax with respect to that item of income that is at least as low as the rate claimed

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under this DTT by the CIV with respect to that item of income.

For the purposes of this provision, CIV means:

- UCITS subject to Part I of the Luxembourg law of 17 December 2010;
- UCIs subject to Part II of the Luxembourg law of 17 December 2010;
- Specialised Investment Funds ("**SIF**") and Reserved Alternative Investment Funds ("**RAIF**") subject to the "SIF-like" tax regime;
- Any other investment fund, arrangement or entity established in Luxembourg which the competent authorities of the Contracting States agree to regard as a CIV.

The granting of DTT benefits to Luxembourg CIVs is a very positive change compared to the situation of CIVs under the old tax treaty. The fact that the "equivalent beneficiary" requirement will not apply to UCITS is also very positive. In practice, investors in UCITS are numerous and may change daily, which makes it extremely difficult in practice to track particular income streams to particular investors in order to determine whether the UCITS is held by equivalent beneficiaries.

That said, for non-UCITS CIVs, so mainly for alternative investment funds, the analysis of the "equivalent beneficiary" condition will remain a challenging exercise, especially when the investor base is significant.

Finally, as far as the CIV definition is concerned, the fact that RAIFs subject to the SICAR regime are not CIVs within the meaning of this provision makes sense because they are fully taxable entities under Luxembourg tax law and are therefore already to be considered as tax residents under the DTT.

New tie-breaker rule for dual resident companies

So far, almost all Luxembourg tax treaties include a tie-breaker rule according to which a company is deemed to be resident in the Contracting State which its place of effective management is situated in.

The new DTT (Article 4) now incorporates the mutual agreement procedure for dual resident companies.

These provisions were included in the 2017 OECD Model Tax Convention and require agreement by the competent authorities of Luxembourg and the UK, having regard to a number of factors.

This change will bring a lot of tax uncertainty to corporate taxpayers which rely on DTT benefits and have their place of incorporation in one country and their place of effective management in the other. In those instances, the place of effective management criterion will no longer prevail automatically when determining the tax residence.

In order to determine by mutual agreement the Contracting State of which a company shall be deemed to be a resident for the purposes of the DTT, the competent authorities will have a look notably at the following factors:

- Location of senior management of the company;
- Location of director and board meetings (or equivalent);
- Location of the headquarters;
- The extent and nature of the economic nexus of the company in Luxembourg and the UK; and
- Whether determining that the company is a resident in one of the countries but not the other for the purposes of the DTT would carry the risk of an improper use of the DTT or inappropriate application of the domestic law of the UK or Luxembourg.

Any matters requiring mutual agreement on a case-by-case basis by competent authorities tends to be lengthy. It remains to be seen whether this will result in significant scrutiny by the tax authorities in Luxembourg or HM Revenue & Customs in the UK.

Finally, the Protocol to the DTT provides that the competent authorities of Luxembourg and the UK will not seek to revisit the tax residence status determined under the old tax treaty rules (but only as long as all the material facts remain the same). Any changes to the tax residence status of a company will apply only to income or gains arising after the new determination (or notice to the taxpayer of the absence of an agreement).

Dividends

The DTT introduces a full exemption from dividend withholding tax, provided that the recipient of the dividend is the beneficial owner of the income.

One of the effects of Brexit was that the EU Parent Subsidiary Directive removed the exemption from dividend withholding tax and UK recipients of Luxembourg dividends reverted to the old treaty rate of 5%. The change introduced by the new DTT therefore reinstates the previous position.

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The UK does not levy withholding tax on dividends, other than for certain distributions from real estate investment trusts ("**REITs**").

The exemption from dividend withholding tax does not apply to such distributions from UK REITs; they are subject to 20% UK withholding tax at source but the DTT provides for a reduction (by way of reclaim) such that the final rate is 15%.

It is good to see that recognised pension funds[1] can benefit from a withholding tax exemption on UK REIT distributions. This is feature of a number of recently renegotiated treaties of the UK.

Interest

Like in the old tax treaty, Article 11 of the DTT provides that there should be no withholding tax on interest as long as it is beneficially owned by a resident of the other country. While Luxembourg does not levy withholding tax on interest, the UK does at 20%.

Royalties

The change to the DTT in relation to withholding tax on royalties is again reflecting the fact that these were previously covered by an EU Directive. The full exemption from withholding tax on royalties owned by a treaty beneficiary removes the 5% rate of the old tax treaty. This is of primary benefit to Luxembourg taxpayers holding IP investments in the UK as royalties may be subject to up to 20% withholding tax.

Capital gains & real estate rich companies

One of the most significant changes is that the DTT now gives the UK taxing rights on capital gains realised on the sale of shares/interest in companies holding UK real estate where these are owned by Luxembourg tax residents. The old tax treaty gave taxing rights to Luxembourg (with a potential full exemption of the gains in Luxembourg under the participation exemption regime) and this was not in line with the majority of other double tax treaties the UK has.

Given that the UK changed its domestic law in April 2019 to tax non-UK resident owners of commercial property (both direct and indirect), this change was widely expected.

The new DTT (in Article 13) introduces a "real estate rich company" clause according to which gains from the disposal of shares or comparable interests deriving more than 50% of their value directly or indirectly from immovable property may now be taxed in the country where the real estate is located.

Based on this new provision, the UK will now be able to tax gains realised by Luxembourg investors on shares or comparable interests in another company (no matter the country in which that company is a tax resident in), which is considered to be "property-rich" from a UK tax perspective.

As this is not a change to UK domestic law, any gains realised after commencement will be subject to UK tax. This is important given that even gains accrued prior to the DTT coming into force can be subject to tax.

UK tax law provides for the base cost of commercial real estate to be uplifted to April 2019 values and any gain to be calculated by reference to that value. Consideration also needs to be given as to whether this change impacts the recognition of deferred tax in company financial statements.

Methods to eliminate double taxation

Luxembourg will generally apply the exemption method to eliminate double taxation.

However, the credit method will apply in certain situations, including when tax is levied in the UK in accordance with Article 10 (dividend withholding tax) or Article 13 (capital gain taxation). In such case, the deduction shall not exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income or gains derived from the UK.

The UK similarly applies the exemption method to eliminate double taxation. In instances where this is not applicable a UK tax credit should be available, subject to a 10% ownership threshold.

Prevention of DTT abuse

The so-called "principal purpose test", already included in the old tax treaty since the entry into force of the MLI, is

[1] Luxembourg recognised pension funds includes Pension-savings companies with variable capital (***sociétés d'épargne-pension à capital variable***, "**SEPCAV**"), Pension-savings associations (***associations d'épargne-pension***: "**ASSEP**"), Pension funds subject to supervision and regulation by the Insurance Commissioner (***Commissariat aux assurances***) and the Social Security Compensation Fund (***Fonds de Compensation de la Sécurité Sociale***: "**SICAV-FIS**").

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also included in the new DTT. Accordingly, a DTT benefit shall not be granted in respect of an item of income or capital if obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit. These provisions will not be invoked if it can be shown that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the DTT.

In addition, and in line with most other double tax treaties negotiated in recent years, the UK and Luxembourg intend to conclude a DTT without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this DTT for the indirect benefit of residents of third States).

Entry into force

The new DTT will enter into force as soon as it has been ratified by both Luxembourg and the UK. Since the UK has already ratified the DTT and assuming that Luxembourg will finalise its ratification procedure prior to year-end, the new DTT will probably enter into force in the course of 2023. Should it be the case, the new provisions would become applicable as follows:

In Luxembourg, it would apply:

i. in respect of taxes withheld at source, to income derived on or after 1 January 2024; and

ii. in respect of other taxes on income, and taxes on capital, to taxes chargeable for any taxable year beginning on or after 1 January 2024.

In the UK, the DTT would apply:

i. in respect of taxes withheld at source, to income derived from 1 January 2024;
ii. in respect of income and capital gains tax, to any year of assessment from 6 April 2024;
iii. for corporation tax (including corporation tax on capital gains), for any financial year beginning on or after 1 April 2024.

In the UK, whilst for corporation taxpayers, the earliest the new treaty could apply is therefore 1 April 2024, in reality it could be the year after. A number of companies and groups have financial years starting 1 January and for these the DTT would only apply from 1 January 2025.

We will continue to monitor the ratification proceedings and provide updates.

Implications

As highlighted above, the DTT introduces a number of changes and in certain cases (particularly for real estate investors) very significant changes.

It is important that the impact of the changes is carefully considered from a group/fund structure perspective, expected and modelled returns, cash requirements and financial reporting.

The impact of the new DTT should also be carefully considered by dual residence companies in order to make sure that their current tax residence for DTT purposes is not impacted.

It is without doubt that the DTT will be positive for Luxembourg CIVs investing in the UK as they will now be able, under certain conditions, to benefit from an exemption of UK withholding tax on interest and they already benefit from the dividend withholding tax exemption under the UK internal rules.

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