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GREAT FUND INSIGHTS

The new Luxembourg/ United-Kingdom tax treaty has finally been signed!

More than four years after the announcement of negotiations, the new tax treaty between Luxembourg and the United Kingdom was finally signed on 7 June 2022, together with a Protocol adding further detail. As expected, the new tax treaty is broadly in line with the most recent OECD Model Tax Convention and notably includes a "property-rich clause" as well as a principal purpose test provision. It also narrows the circumstances in which withholding will be required from payments of dividends and interest and (through the Protocol) provides additional details on the types of investment vehicles that will be regarded as resident.

The treaty must be ratified by each country before it can come into force and is expected to have effect in 2023 at the earliest.

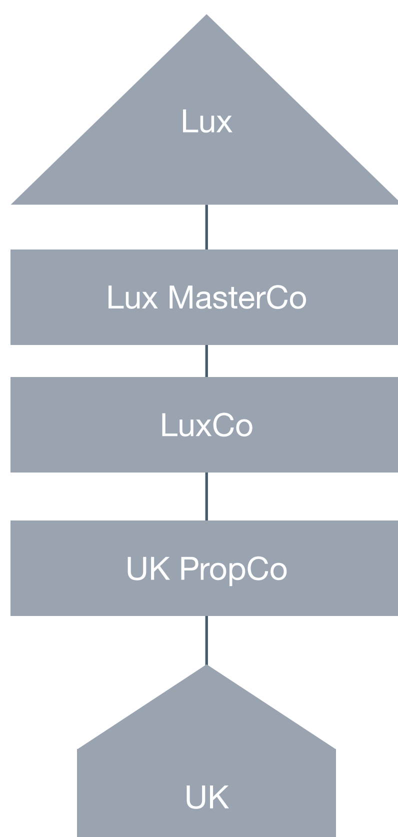
New rules for gains realised by entities holding indirectly UK real estate

One of the most significant changes effected by the new treaty relates to the taxation of gains deriving directly or indirectly from real estate located in a Contracting State pursuant to the so-called "property-rich clause". This is particularly relevant from a UK tax perspective because a non-resident capital gains tax (NRCGT) applies (at rates of up to 28%) to gains deriving from direct or indirect disposals of UK land realised by non-residents. This will include the disposal of an asset (for example, shares in a company) that derives at least 75% of its value from UK land, provided other conditions are met – notably that the seller or persons connected to it must hold 25% or more of the shares.

Under the existing treaty, any gain realised by a Luxembourg-resident company on the disposal of shares held in a subsidiary holding UK properties is taxable in Luxembourg only. Such a gain usually benefits from the Luxembourg participation exemption and is thus not taxed in Luxembourg in accordance with Luxembourg tax law.

In line with the most recent OECD model, the new treaty affords taxing rights to the Contracting State where the investment derives more than 50% of its value directly or indirectly from property situated there. However, this differs from the UK NRCGT, for which "property-rich" is defined by reference to a percentage of at least 75%. A treaty cannot impose a tax liability where none exists under domestic law so, under the new treaty, a Luxembourg resident selling shares will only be subject to UK NRCGT if the asset derives at least 75% of its value from UK land.

Using the following structure as an example, any gains realised by Lux MasterCo upon the disposal of LuxCo's shares and by LuxCo upon the disposal of UK PropCo's shares would not generally be subject to tax in either jurisdiction, with the seller benefitting from the participation exemption under Luxembourg domestic law and the terms of the existing treaty preventing a UK NRCGT liability. However under the new treaty the UK will be allowed to apply NRCGT in both cases, provided that certain additional conditions are met.



Additional clarifications on meaning of "resident"

The new treaty includes a number of changes to the scope of residence, as well as some important clarifications. In particular, the place of corporate residence tie-breaker has been replaced with a provision requiring the competent authorities to agree residence (in line with the BEPS recommendations).

The Protocol to the new treaty also extends its benefit to certain specific Luxembourg collective investment vehicles (CIV) incorporated under the form of a company for tax purposes (for example, a SA, SCA or S.à r.l.). The new treaty treats these as Luxembourg resident individuals and in principle the beneficial owners of income received from the UK provided that the collective investment vehicle is a UCITS (within the meaning of EU Directive 2009/65) or at least 75% of beneficial interests in the collective investment vehicle are owned by "equivalent beneficiaries".

For these purposes, an equivalent beneficiary means a resident of Luxembourg or of any other jurisdiction with which the United Kingdom has an information exchange agreement and who would be entitled to at least the same tax rate for the respective income received by the CIV under the relevant tax treaty entered into with the UK.

The following Luxembourg CIVs are included:

- Undertakings for Collective Investment in Transferable Securities (UCITS) and Undertakings for Collective Investment (UCI) subject to the law of 17 December 2010;
- Specialised Investment Funds (SIF) subject to the law of 13 February 2007.
- Reserved Alternative Investment Funds (RAIF) subject to the law of 23 July 2016 (unless the RAIF opts for the specific tax regime applicable to SICAR);
- Any other Luxembourg investment fund, arrangement or entity that the tax authorities of each country agree should be included.

This could potentially be significant for debt funds established in Luxembourg and that lend to UK borrowers, as payments of UK source interest to non-UK lenders are generally subject to 20% withholding tax unless relief under a treaty is available. It provides greater choice of lending vehicle for such funds (although care would need to be taken on widely marketed funds to keep track of the 75% equivalent beneficiary requirement).

Finally, recognised pension funds (such as Luxembourg ASSEP and SEPCAV and UK pension schemes) and charities are also expressly treated as resident for the purposes of the new treaty.

No more withholding tax

Under the existing treaty dividends are subject to withholding tax at rates of either 5% (payable to corporate shareholders with at least 25% control) and 15% (otherwise). According to the new treaty, dividends will no longer be subject to withholding tax except in certain circumstances where the dividends are paid by investment vehicles out of income derived directly or indirectly from immovable property.

This is potentially significant in relation to the UK's new qualifying asset holding company (QAHC) regime. A 15% withholding tax is in principle applicable on dividends distributed by a fully taxable Luxembourg-resident company (subject to the availability of the Luxembourg participation exemption, which requires that the parent company is liable to an income tax similar to the Luxembourg corporate income tax). It is not clear that a QAHC would satisfy the requirements of the participation exemption regime. However, the effect of the new treaty is that there should be no withholding tax in any event on a dividend paid by a Luxembourg subsidiary to a UK QAHC.

REITs cannot benefit from the exemption pursuant to the new treaty. Indeed, in such a case dividends may be subject to a 15% withholding tax, unless the beneficial owner is a recognised pension fund established in a Contracting State.

Interest under the existing treaty is not subject to withholding tax, and this remains the case under the new treaty. In addition, in the case of royalties, the existing 5% withholding will be removed. This exemption is however not relevant from a Luxembourg tax perspective, as no withholding tax is currently levied in Luxembourg on interest (except in very specific cases) and royalties. As noted above, it is significant in relation to loans by Luxembourg residents to UK borrowers, as the UK levies 20% withholding tax on interest. The UK also charges withholding tax on certain royalty payments.

Additional points to note

In line with the minimum standards of the BEPS treaty recommendations, the new treaty contains a principal purpose test, under which tax treaty benefits will be denied in case of treaty shopping. Similarly, the preamble also emphasises that the purpose of the treaty is to eliminate double taxation without creating opportunities for evasion or avoidance. The Protocol further expressly confirms that nothing in the new treaty will prevent the application of the CFC rules (deriving from ATAD 1) for Luxembourg tax purposes.

Entry into force

The new treaty must be ratified by each country and that ratification must be notified to the other Contracting State before the treaty can come into force.

In Luxembourg, ratification requires that a Luxembourg law approving the new treaty should be passed by the Luxembourg Parliament and published in the Luxembourg *Mémorial*. In the UK, the new treaty must be incorporated into domestic law as the Schedule to an Order in Council and published as a statutory instrument.

Regarding withholding taxes, the new treaty will apply to income derived on or after 1 January of the year following the year in which the treaty enters into force, thus from 1 January 2023 at the earliest.

For income taxes, since the fiscal year is different in Luxembourg and the UK the new treaty will apply as follows;

– Regarding UK taxes, to taxes chargeable for the financial year or year of assessment beginning on or after 1 April (in relation to companies paying corporation tax) or 6 April (for other taxpayers) of the calendar year following the year in which the treaty enters into force (1 April 2023 at the earliest)

– Regarding Luxembourg taxes, to taxes chargeable for any taxable year beginning on or after 1 January of the calendar year following the year in which the treaty enters into force (1 January 2023 at the earliest).

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CS2207_CDD-69523_ADD-101874