Analysis

The new Luxembourg/UK DTT: real estate implications

Speed read

A new double tax treaty has been signed between Luxembourg and UK. Once it comes into effect, a beneficial new lower rate of dividend withholding will be available and treaty benefits will be extended to certain fund structures; however, certain real estate holding structures relying on protections in the old treaty will become taxable in the UK without grandfathering. Luxembourg structures should be reviewed in light this and other international developments, especially as there may now be suitable alternatives.

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On 7 June 2022, the UK and Luxembourg signed a new double tax treaty and protocol. The 1967 treaty it will replace is one of the older treaties and retains provisions that are important to certain Luxembourg holding company structures. However, the new treaty reflects recent, post-BEPS models of balancing taxing rights between states. When combined with other developments, such as the proposed Unshell EU Directive (ATAD 3) and a new qualifying asset holding company (QAHC) regime in the UK, the new treaty will likely be a significant factor for re-evaluating old structures.

Withholding taxes

UK holding companies are no longer able to access the Parent Subsidiary Directive or Interest and Royalties Directive. It is therefore interesting to see the position agreed in respect of withholding taxes in the first treaty to be signed with an EU27 state after Brexit – although of course negotiations have been in progress for several years.

Dividends

The rate of withholding tax on dividends paid out of Luxembourg was previously 15% but reduced to 5% for shareholdings of greater than 25%. This is now reduced to nil (article 10 of the new treaty), and there is no threshold for a qualifying holding. Although Luxembourg's implementation of the parent subsidiary directive extends benefits to any company fully liable to corporate income tax located in a full treaty country, there are the additional qualifying conditions as to holding period, and minimum holding of 10% or cost of €1.2m. The new treaty is therefore welcome news for groups holding European business through a Luxembourg holding company, and for investors (including recognised pension schemes) in Luxembourg funds or fund holding company platforms.

REITs which are themselves exempt from tax on income, but required to distribute income arising from immovable property upon which withholding may arise, may qualify for a new specific provision limiting the withholding tax 15% and to nil if paid to a recognised pension scheme. However, this is not a fundamental change as the holder of excessive rights rule acts as a barrier (in the form of a charge on the REIT) to a REIT having a foreign single corporate shareholder of greater than 10%.

Interest

The nil rate of withholding tax on interest payments remains the same (article 11).

Royalties

The rate of withholding tax applicable to royalties has been reduced from 5% to 0% (article 12).

Entitlement to treaty benefits

The existing treaty had been updated by the multilateral instrument to include the principal purposes test and this is now included at article 28. A fuller limitation of benefits article is not included.

Of course, beneficial ownership of income is required in order to benefit from treaty relief and groups with Luxembourg holding companies will be familiar with transfer pricing arrangements designed to demonstrate the holding company is beneficial owner of, say, interest paid on intra-group debt.

With both the existing treaty and new treaty affording a nil rate of withholding on interest, it may be tempting to assume the status quo is preserved. However, the European Commission's proposed Unshell Directive gives cause to think again. Companies that pass through three initial gateway tests will be required to assess themselves against substance indicators around having premises, local bank accounts, and resident directors and employees; a company with one or more indicators will be denied access to EU directives and may only be issued with a residency certificate by the member state if that certificate clearly says the company is a shell company. Payments will be treated as if they flow through the shell company and receipts will be taxed on the shareholder. Companies holding real estate for individuals will be taxed in the country where the property is located as if the individual owned the property.

The initial gateway tests are: (i) whether 75% or more of the entity's revenues in the previous two tax years are from activities other than the company's own trade, or if 75% of its assets are real estate or private property of high value; (ii) whether a majority of revenues are from international transactions, or income is passed on to other jurisdictions; and (iii) whether management and administration services are performed in-house or are outsourced.

Residence

The tie breaker provision in article 4 is aligned with the provisions of the 2017 OECD Model Tax Convention, requiring a mutual agreement procedure for dual resident companies. The protocol accompanying the treated provides

more details of the factors to be used by the competent authorities for determining residence for treaty purposes. The factors echo ATAD 3, namely:

- the location of senior management;
- the location of director and board meetings (or equivalent);
- the location of headquarters;
- the extent and nature of the economic nexus of the company; and
- whether determining the residence in one of the jurisdictions but not of the other country for the purposes of the treaty would carry the risk of an improper use of the DTT or inappropriate application of the domestic law of the UK or Luxembourg.

For companies whose tax residence has been determined under the existing treaty, it remains to be seen whether the competent authorities in both countries will not seek to revisit the tax residency position unless there is a material change of facts.

Capital gains

The existing treaty does not contain a property-rich clause and therefore disposals of shareholdings in Luxembourg companies owning UK real estate could escape UK gains tax, depending on the residency of the shareholder. However, article 13(2) of the new treaty will give primary taxing rights to the UK in such circumstances. This is the most significant change which will have a major impact for existing UK real estate investment structures held under Luxembourg holding company platforms.

The property rich company threshold under the treaty is shares or comparable interests deriving more than 50% of their value directly or indirectly from immovable property which is lower than the 75% threshold under UK domestic law. This means the UK will only tax capital gains from a disposal of a UK property rich company shares if those shares derive at least 75% of their value, directly or indirectly, from UK real estate.

There are no grandfathering provisions for existing structures, so once the new treaty comes into force any capital gain arising to a Luxembourg resident from a disposal of shares that derive their value from UK real estate will be subject to UK tax. Of course, domestic law still applies and, provided that the entity had remained non-UK tax resident, only the amount of capital gain accruing post 5 April 2019 will be brought within the charge to UK tax.

The treaty changes and ATAD 3 serve as a strong prompt to review real estate holding structures involving Luxembourg.

Funds

Asset holding company/REIT as an alternative?

As the protection from UK capital gains tax afforded to Luxembourg holding structures by the existing treaty will disappear under the new treaty the playing field for real estate investors will be somewhat levelled and alternative structure may seem comparatively more attractive.

Subject to legal, regulatory, tax and commercial constraints investors may consider UK REITs under which UK tax exposure is limited to the rate of withholding tax on property income distributions. There is the additional benefit of no further tax filing or reporting requirements for non-UK resident investors

Domestication of structures in the UK may also be attractive for pan-European funds. Parallel structures, such as a UK REIT and a QAHC, may provide more flexibility and suitable management of tax exposure whilst permitting maintenance of the structure by onshore highly skilled investment management professionals.

Treaty access for collective investment vehicles

Even handed, the protocol accompanying the treaty provides guidance on treaty access to collective investment vehicles (CIVs), which is potentially beneficial to Luxembourg structures.

From a Luxembourg tax perspective, a CIV (for example, UCITs/UCIs, SIFs, RAIFs and any other investment fund as agreed by the competent authorities) which is established and treated as a body corporate for tax purposes and receives UK source income, will be treated as Luxembourg tax resident and beneficial owner of that income. This will only be the case to the extent that the beneficial interests in the CIV are owned by equivalent beneficiaries.

The term 'equivalent beneficiaries' means a resident of Luxembourg and a resident of any other jurisdiction with which the UK has arrangements that provide for effective and comprehensive information exchange, who would be entitled to a rate of tax on the same item of income which is at least as low as the rate claimed under the treaty by the CIV.

In addition, if at least 75% of the beneficial interests in the CIV are owned by equivalent beneficiaries, or if the collective investment vehicle qualifies as an UCITS within the meaning of EU Directive 2009/65, the CIV will be treated as Luxembourg tax resident and the beneficial owner of all the income it receives (provided a Luxembourg tax resident receiving the income in the same circumstances would have been considered to be beneficial owner of the income).

Entry into force

Assuming the treaty is ratified by both countries this year (although noting that some treaties have taken years to ratify), the treaty will enter into force on the following dates:

- in the UK: 1 January 2023 for income derived from any taxes withheld at source; 6 April 2023 in respect of income and CGT; and 1 April 2023 (at the earliest) for corporation tax, or 1 January 2024 if the relevant companies have financial years starting at 1 January 2023; and
- in Luxembourg: 1 January 20213 for income derived from any taxes withheld at source; and the taxable year beginning on or after 1 January 2023 for other taxes on income and capital.

Actions

Prior to the treaty coming into force, investors and fund managers should consider the following:

- exit strategies and whether exit at a particular level would meet the property rich company test;
- making tax exemption elections under TCGA 1992 Sch 5AAA para 12;
- ascertaining the market value of property interests held at April 2019 and the market value of shares as at 5 April 2019 for pre-April 2019 structures;
- revisiting underwriting assumptions and factor in any latent capital gains discounts and rate of corporation tax increase to 25% from 1 April 2023;
- ascertaining investors tax profile and whether the disposal would qualify under the extended substantial shareholding exemption;
- subject to investment and regulatory constraints, alternative investment structures, including use of a UK REIT to invest in UK real estate; and
- the domestication of existing structures, including use of a QAHC for non-UK real estate investments. ■

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▶ New UK/Luxembourg DTT (E Clark, J Woodall & I Zeider, 22.6.22)