TAXAND

Signature of the first double tax treaty between Luxembourg and Cyprus - What will the impact be on cross border structuring?

1. Introduction and background

On 8 May 2017, Luxembourg and Cyprus signed their first double tax treaty (“**Lux/Cyprus DTT**”). Through this tax treaty, both countries aim to strengthen their economic and commercial relationship. While Cyprus broadens its tax treaty network as Luxembourg was one of the few EU countries with which it had not yet signed a double tax treaty, Luxembourg fills the only remaining gap in its network of tax treaties with EU Member States.

On 7 June 2017, both Luxembourg and Cyprus also signed the multilateral convention (the “**MLI**”) to implement tax treaty related measures aimed at preventing Base Erosion and Profit Shifting (“**BEPS**”). However, neither of the 2 States listed the Lux/Cyprus DTT as a convention covered by the MLI given that the lists of covered tax treaties only contain tax treaties in force. As a result, once ratified, the MLI will not modify the Lux/Cyprus DTT. However, the Lux/Cyprus DTT already provides for the OECD’s BEPS recommendations. In addition, the Lux/Cyprus DTT generally follows the OECD Model Convention and includes the latest international standards with regard to exchange of information.

To the extent, the ratification process is completed by both Luxembourg and Cyprus before the end of 2017, the Lux/Cyprus DTT will apply as from 1 January 2018[1].

This article will examine the most relevant clauses of the Lux/Cyprus DTT and their impact on tax structuring, both from a Luxembourg and a Cyprus point of view.

2. Principal purpose test

In order to address some forms of treaty abuse, the Lux/Cyprus DTT contains a principal purpose test (“**PPT**”) in accordance with Actions 6 and 15 of the BEPS Action Plan and in line with the guiding principle of paragraph 9.5 of the Commentary included in the draft contents of the 2017 Update to OECD Model Convention. Under this PPT, a Lux/Cyprus DTT benefit will be denied if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction (*subjective test*). The fact that the wording “one of the principal purposes” has been chosen instead of wordings such as “sole purpose”, “essential purpose” or “predominant purpose”, makes it easier for the tax authorities to establish that the subjective test is met.

Despite the fact that the subjective test, as defined above, would be met, a Lux/Cyprus DTT benefit would only be granted in the case where the taxpayer can prove that granting such benefit, in the circumstances at hand, is still in accordance with the object and purpose of the relevant provisions of the Lux/Cyprus DTT (*objective test*). The objective test is not easy to interpret and, in practice, it might be difficult to determine what the object and purpose of the Lux/Cyprus DTT provisions are. It is therefore recommended to seek advice from a tax adviser when setting up cross border structuring.

[1] In respect to taxes withheld at source, income derived on or after 1 January of the calendar year next following the year in which the Treaty enters into force - In respect to other taxes on income, and taxes on capital, taxes chargeable for any taxable year beginning on or after 1 January of the calendar year next following the year in which the Treaty enters into force.

3. Resident covered by the Lux/Cyprus DTT- Collective investments

The Lux/Cyprus DTT defines a “*resident of a Contracting State*” for the purposes of the Convention as any person, including a collective investment vehicle, who, under the domestic laws of that State, is liable to tax in that State by reason of its domicile, residence, place of management or any other criterion of a similar nature. For legal persons, in case of conflict of residence (i.e. in case they are considered as a resident of both Luxembourg and Cyprus), they are considered as resident in the country in which they have their place of effective management. A person cannot be considered a “*resident of a Contracting State*” if such person is considered to be a tax resident but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State.

For the purpose of the Lux/Cyprus DTT, a collective investment vehicle is considered as a resident if it is liable to tax therein by reason of its domicile, residence, place of management or any other criterion of a similar nature. A collective investment vehicle is also considered as liable to tax if it is subject to the tax laws of the Contracting State concerned, but is exempt from tax only if it meets all of the exemption requirements specified in the domestic tax laws of that State. A collective investment vehicle is deemed to be the beneficial owner of any income it receives.

From a Luxembourg perspective, this means that collective investment vehicles in corporate form as referred to in article 159 of the Income Tax Law (i.e.: UCIs in SICAV or SICAF form, SICAV-SIF/SICAF-SIF, RAIFs in corporate form as well as fiscally opaque SICARs) should be entitled to Lux/Cyprus DTT benefits. On the contrary, collective investment vehicles treated as tax transparent for Luxembourg tax purposes (i.e.: UCIs or SIF set up as FCPs) will not be able to benefit from the Lux/Cyprus DTT provisions. However, if the tax transparency of the entity is recognised, investors may be protected under the double tax treaty concluded between the investor country of residence and the country of the source income.

Similar provisions also apply for Cyprus purposes, where any form of collective investment vehicle in corporate form such as limited liability companies or public companies with management and control in Cyprus would be entitled to benefit from the Lux/Cyprus DTT provisions, whilst tax transparent entities such as partnerships would not be entitled to these benefits.

4. Income from investments in immovable properties and movable assets

a. Real estate

Any income derived by a resident of a Contracting State from the direct use, letting, or use in any other form of immovable property situated in a Contracting State may be taxed in the latter Contracting State. The right to tax of the State of source has priority over the right to tax of the other State and also applies in the case of an enterprise, where income is only indirectly derived from immovable property. To avoid double taxation of the foreign real estate income of its residents, Luxembourg will exempt such income and Cyprus will grant a tax credit for the foreign tax.

b. Dividend

Under the Lux/Cyprus DTT, dividends can be taxed both by the source State and by the State of residence of the beneficiary. However, the treaty caps the withholding tax rates that could be levied by the foreign source State as follows:

- 0% in the case where the beneficial owner is a Company other than a partnership which holds a participation of at least 10% in the paying company;
- 5% in all other cases.

Consequently, the Lux/Cyprus DTT provides (1) for a general withholding tax rate which is lower than the domestic general withholding tax rate of 15% in Luxembourg and 17% in Cyprus, and (2) for a withholding tax exemption under less restrictive conditions than the ones applicable under either the Luxembourg participation exemption regime (as no holding period is required), or the Cyprus participation exemption regime (as no minimum taxation and no activity condition is required).

To avoid double taxation of the foreign dividend received by their residents, Luxembourg will grant a tax deduction equal to the tax paid in Cyprus, and Cyprus will grant a tax credit.

c. Interest and royalties

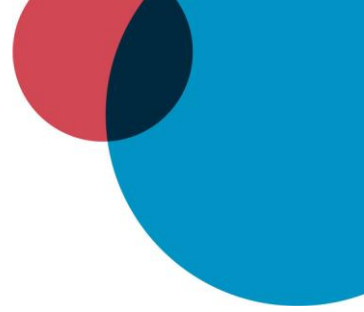
According to the Lux/Cyprus DTT, interest and royalties are only taxable in the Contracting State in which the recipients of the income are resident. Therefore, no withholding tax can be withheld in the foreign source State. For interest income, the Lux/Cyprus DTT makes this rule subject to the legal acts of the European Union. However, under their domestic tax laws, neither Luxembourg nor Cyprus levy withholding tax on interest or on royalties paid to tax residents in the other country.

5. Capital gain on investments in immovable properties and movable assets

Pursuant to the Lux/Cyprus DTT, capital gains on immovable properties located in a Contracting State may be taxed in that State, whereas capital gains on shares are taxable only in the State of which the alienator is a resident. The Lux/Cyprus DTT provides, however, that gains derived from the alienation of shares deriving more than 50% of their value directly from immovable properties (“real estate-rich”) may be taxable in the State where the immovable property is located.

Therefore, it appears that if the value of the real estate-rich company is indirectly (and not directly) derived from immovable property, capital gains on the shares held in such companies remain taxable only in the State of which the alienator is a resident. Consequently, subject to the PTT, the capital gain realised on the sale of the shares in the parent company of a real estate-rich subsidiary should be taxable only in the State of which the alienator is a resident.

To avoid double taxation of capital gains realised by their residents on the disposal of immovable properties and movable assets, Luxembourg will exempt such income and Cyprus will grant a tax credit for foreign tax.



6. Offshore activities from a Cyprus point of view

The exercise by a Luxembourg company of offshore activities related to the exploration or exploitation of the seabed or subsoil or natural resources situated in Cyprus constitutes a permanent establishment of that company in Cyprus unless such activities are carried out for a period not exceeding 30 days in the aggregate in any twelve-month period. For the purposes of the application of the latter provision, if two enterprises are associated and exercise substantially the same activities, the activities are considered as exercised by the last-mentioned enterprise.

On the contrary, in the case where a Luxembourg company is engaged in the transportation of supplies or personnel to a location, or between locations, where activities related to the exploration and exploitation of the seabed or subsoil or natural resources are being carried out in Cyprus or from the operation of tugboats and other vessels auxiliary to such activities, the income of such activities shall be taxable only in Luxembourg. If a company resident of Luxembourg derives gains from the alienation of a) exploration or exploitation rights b) property situated in Cyprus or c) of shares deriving their value from rights or such property or from such rights and such property taken together, this company may be taxed in Cyprus.

Conclusion

The Lux/Cyprus DTT is a new tool for international structuring. Taxand Members in Luxembourg and Cyprus are at your disposal to elaborate further on the impact which the Lux/Cyprus DTT might have on your existing business or to discuss the new business opportunities that may arise between those two countries.

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