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Real Estate Investment in France: Amendment of the France – Luxembourg Tax Treaty

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Teaser: France and Luxembourg recently signed a protocol amending the France – Luxembourg tax treaty (the "**Tax Treaty**"). Such amendment will have an impact on the tax treatment of capital gains realized by Luxembourg entities upon the disposal of French real estate in France. Investors may need to reconsider their holding structure and possibly act before the new provisions become effective.

Client Alert:

Luxembourg is currently widely used as a location for holding investments in French real estate. There are various reasons why Luxembourg is so popular. First, it provides a stable environment from both a financial and regulatory point of view. Second, it has an extensive and favorable treaty network (especially with France) and benefits from EU legislation. Third, it provides a full exemption on qualifying dividends and capital gains. Last but not least, there are various Luxembourg domestic provisions that allow them to distribute proceeds to final investors free from any withholding tax, even to non treaty protected investors. A lot of investment funds typically have structured their investment in French commercial (or residential) property through a Luxembourg holding company, as such a holding allows them to avoid a French domestic 33.33% withholding tax on gains on shares of French real estate companies (NB: in France, it is quite common to hold property through real estate companies for various tax and non tax reasons). This is due to the fact that under the current drafting of the Tax Treaty (unlike most treaties signed by France), no specific provision allows France to tax capital gains arising when a Luxembourg resident disposes of its shares in a real estate company owning French assets. Such gains are therefore only taxable in Luxembourg, which exempts such gains under its domestic participation exemption. This is due to change.

The French and Luxembourg Finance Ministers signed, on 5 September 2014, a protocol (the "**Protocol**") amending the Tax Treaty.

The Protocol introduces new provisions regarding the taxation of capital gains arising on the disposal of participations in so-called "real estate entities" (*sociétés à prépondérance immobilière*), defined as companies, trusts, or any other institutions or entities whose assets or property constitute more than 50% of their value, or which derive more than 50% of their value – directly or indirectly through one or more companies, trusts, institutions, or entities – from immovable property located in a given contracting state.

According to the Protocol, such capital gains will be subject to tax in the state where the real estate property is located. The main exclusion to this new rule concerns the case of a company that uses the real estate for its own commercial or industrial activities. This will most likely not include the mere renting of the building.

As a result, the sale by a Luxembourg entity of its shares (or any other similar instruments) in an entity (whether located in France, Luxembourg, or elsewhere) owning predominantly, directly or indirectly, French real estate will in the future be subject in France to a 33.33% capital gain tax.

This is a significant amendment since as mentioned above, under the current Tax Treaty, such capital gains were not taxable in France.

The Protocol has yet to be ratified by the respective Parliaments of France and Luxembourg. It can be expected that the Protocol will probably enter into force on 1 January 2015 or (more likely) 1 January 2016, depending on the delay of ratification in each country.

Taxpayers should therefore as soon as possible carefully review their structure and assess the potential impact that the Protocol may have. The timeframe may be quite short, especially if both Parliaments ratify the Protocol before year end (in which case the treaty will enter into force on 1 January 2015). For future investments, alternative structures and/or locations need to be considered.

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