New Luxembourg-UK tax treaty

An opportunity for Luxembourg debt funds?

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The Grand Duchy of Luxembourg and the United Kingdom of Great Britain and Northern Ireland (the "UK") signed a new treaty for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance on 7 June 2022 (the "New Treaty"). A new treaty was overdue to consider Brexit and certain BEPS (*base erosion and profit shifting*) actions initiated by the OECD.

The New Treaty will enter into force on 1 January 2024 for Luxembourg and UK withholding taxes as well as for all other Luxembourg taxes[1] and will replace the previous treaty in force between the two jurisdictions (the "**Preceding Treaty**")[2].

One of the key changes introduced by the New Treaty, to be found in point 2. of its protocol (the "**Protocol**"), is that Luxembourg investment funds (referred to in the New Treaty as collective investment vehicles, "**CIVs**") may now, under certain conditions, be considered as Luxembourg residents and benefit from the New Treaty and notably the absence withholding tax rates[3].

As the UK does not levy withholding tax on dividends but levies a 20% withholding tax on "yearly" interest, the New Treaty could represent a new opportunity for Luxembourg debt funds, especially with the recent and forthcoming regulatory evolutions (AIFMD 2 and ELTIF 2), investing in the UK to benefit from an absence of UK interest withholding tax. This is a major improvement in comparison to the Preceding Treaty under which Luxembourg investment funds were denied treaty access making direct investments in UK debt assets by CIVs unattractive and inefficient.

CIVs in scope

The notion of CIV contained in the Protocol targets investment funds subject to a product law, being:
i. Undertakings for collective investment in transferable securities subject to Part I of the law of 17 December 2010 ("**UCITS**");
ii. Undertakings for collective investments subject to Part II of the law of 17 December 2010 ("**Part II UCIs**");
iii. Specialised investment funds subject to the law of 13 February 2007 ("**SIFs**");
iv. Reserved alternative investment funds ("**RAIFs**") subject to the law of 23 July 2016, provided they do

not opt for the SICAR (*société d'investissement en capital à risque*) regime.

SICARs subject to the law of 15 June 2004 are not considered as CIV. Where incorporated as limited companies, even though benefitting from an objective exemption on qualifying income, they should nevertheless be able to benefit from the New Treaty as any other ordinary company (and not as CIVs) provided they fulfil the necessary requirements. Furthermore SEPCAVs, ASSEPs, pension funds subject to the supervision and regulation by the Insurance Commissioner and the Social Security Compensation Fund SICAV-FIS (defined as "recognised pension fund" under the New Treaty) will be considered as residents and may benefit from the provisions of the New Treaty.

Conditions

The conditions contained in the New Treaty reflect the "proportionate approach" set out in the OECD commentaries to the model tax convention on income and on capital[4] (the "**Model Convention**") stemming from the OECD CIV report[5]. This approach aims to ensure tax neutrality between direct investments and investments through a CIV while at the same time preventing treaty shopping.

A CIV receiving income arising from the UK will be entitled to the New Treaty provided the following conditions are cumulatively met:
1. the CIV is established and treated as body corporate for Luxembourg tax purposes;
2. a Luxembourg resident receiving the income in the same circumstances would have been considered to be the beneficial owner thereof; and
3. the beneficial interest in the CIV is owned by "*equivalent beneficiaries*".

Concerning condition 1., Luxembourg tax transparent vehicles such as special limited partnerships ("**SCSp**") and common limited partnerships ("**SCS**") are denied treaty benefits. Only tax opaque vehicles such as, private limited liability companies ("**Sàrl**"), public limited companies ("**SA**") and partnerships limited by shares ("**SCA**") may be eligible to the New Treaty.

The notion of "*equivalent beneficiaries*"

For the purpose of the New Treaty, "*equivalent beneficiaries*" means (i) a resident of (a) Luxembourg or (b) of any other jurisdiction with which the UK has a double tax treaty ("**DTT**") that provides for effective and comprehensive information exchange and (ii) who would, if he received the particular item of income for which benefits are being claimed under the New Treaty, be entitled under a DTT with the UK, to a rate of tax with respect to an item of income that is at least as low as the rate claimed under the New Treaty by the CIV with respect to that item of income.

In other words, benefit of the New Treaty will only be granted to investors who, had they invested directly, would have received an equivalent DTT benefit to that received by the CIV. This prevents investors from using the CIV to obtain a better tax treatment compared to a direct investment.

Given the UK's extensive DTT network, limb (i)(b) above should be easily met in most cases for foreign investors in a Luxembourg CIV. Limb (ii) implies that fund managers will need to track whether the withholding tax rate applicable under a DTT with an investor's jurisdiction and the UK provides for a rate which is at least as low as the one under the New Treaty. Depending on the number of investors, this can be a burdensome exercise.

However, to mitigate procedural burdens that may arise from the determination of treaty entitlement for every single investor, the New Treaty provides, in line with the Model Convention, for a safe harbour threshold. Accordingly, if at least 75% of the beneficial interest in the CIV are held by "*equivalent beneficiaries*", treaty benefits would be granted to all income received by the CIV (provided a resident of Luxembourg receiving the income in the same circumstances would have been considered to be the beneficial owner thereof). UCITS are however not subject to that threshold and will qualify in any case.

Where less than 75% of the CIV interests are held by *equivalent beneficiaries*, the income of the CIV should qualify for the benefits of the New Treaty in proportion to the interests that are held by *equivalent beneficiaries*.

These provisions are a welcome evolution compared to the Preceding Treaty but will require investment fund managers willing to benefit from the New Treaty to assess whether their investors qualify as equivalent beneficiaries.

Consequences for eligible CIVs

Where the above conditions are met, the CIV will be considered as a Luxembourg resident (under article 4 of the New Treaty) and the beneficial owner of the income it receives. Such CIV will therefore benefit from the provisions of article 11 of the New Treaty and may receive UK interest payments free and clear from UK withholding tax.

An opportunity for Luxembourg debt funds targeting the UK market?

Luxembourg debt funds structures may take various forms (master-feeder structures, single or multiple compartments, parallel fund structures, with or without underlying special purpose vehicle) and have various investment strategies. Experience shows a preference for AIF-SCSps, for unregulated vehicles, and for SIFs and RAIFs, for vehicles with a product cover, with a growing appetite for the latter. Debt fund managers targeting investments in the UK may now consider establishing their investment vehicle as a SIF or a RAIF incorporated as a tax opaque entity (Sàrl, SCA or SA) to benefit from the absence of interest withholding tax under the New Treaty.

The New Treaty will have many benefits for eligible CIVs: it does not only provide for legal certainty, reduce the tax burden at the level of the fund but may also result in a simplification of the investment structures (and diminishing costs in relation thereto).

Sponsors active in the UK debt market should therefore carefully assess the impact of the New Treaty on their existing or projected investments.

1) Provisions regarding UK income tax, capital gains tax and corporation taxes will enter into force later in 2024.
2) Convention between the United Kingdom of Great Britain and the Northern Ireland and the Grand Duchy of Luxembourg for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital signed on 24 May 1967, as amended.
3) Other changes contained in the New Treaty, such as the full relief on dividend and royalties withholding taxes, introduction of a real estate rich clause for capital gain taxation etc, will not be discussed in the present article.
4) OECD Model Tax Convention on Income and on Capital (as it read on 21 November 2017).
5) OECD, The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles (2010).

Fuchs Asset Management becomes Funds Avenue

Fuchs Asset Management, a Luxembourg-based management company and AIFM, announces their rebranding as Funds Avenue. This transformation aligns with their strategic partnership with Trustmoore, a global corporate services company. The rebranding and new partnership strengthen the position of both companies in the Luxembourg financial market.

Funds Avenue's new name marks the beginning of a promising future. This is complemented by the new partnership between Funds Avenue's expert fund management services and Trustmoore's specialized fund administration services. This enables both companies to offer a broader and more comprehensive range of fund services including risk & portfolio management, investor onboarding, fund accounting and financial reporting services. Their combined commitment to provide tailor-made fund solutions creates a streamlined and efficient experience for their clients.

Focus on Values and Relationships

While both companies will retain their unique identities, there is synergy in Funds Avenue and Trustmoore's shared values and beliefs around clients, relationships, and solutions. Both companies have a boutique approach which allows them to create tailor-made services for their clients. They create true understanding about their clients' business and challenges by building long term relationships. This shared commitment to finding solutions for their clients combined with long term vision creates a foundation for success. Whilst the partnership between Funds Avenue and Trustmoore remains subject to the final approval of the CSSF, it will not just be about what they can offer to their clients but about establishing mutual success.

Timothe Fuchs – CEO Funds Avenue: "We are excited to announce our new name. It stands for a new chapter of our company and to combine that with the Trustmoore partnership makes it even more exciting. This alliance is a testimony to the strength of Funds Avenue's core values and our commitment to crafting tailored financial solutions while building genuine, long-term relationships with our clients."

Steven Melkman – Founder Trustmoore: "I am glad that the founding principle of Trustmoore - aligning our success with our clients' success - resonates with Funds Avenue's main principle. This shared value demonstrates a strong commitment to client satisfaction and success. At the same time, I am excited to see our Luxembourg office grow to 90 people with the Funds Avenue team joining us on our Rue Dicks location. The cooperation with Timothe and collective efforts of the Funds Avenue and Trustmoore teams in successfully establishing this partnership has been exemplary in every way and gives me great confidence for the future of our partnership."

Global situation of UCIs at the end of August 2023

As at 31 August 2023, the total net assets of undertakings for collective investment, comprising UCIs subject to the 2010 Law, specialised investment funds and SICARs, amounted to EUR 5,195.645 billion compared to EUR 5,243.579 billion as at 31 July 2023, i.e. a decrease of 0.91% over one month. Over the last twelve months, the volume of net assets decreased by 1.98%.

The Luxembourg UCI industry thus registered a negative variation amounting to EUR 47.934 billion in August. This decrease represents the sum of negative net capital investments of EUR 4.410 billion (-0.08%) and of the negative development of financial markets amounting to EUR 43.524 billion (-0.83%).

The number of undertakings for collective investment (UCIs) taken into consideration totalled 3,323, against 3,324 the previous month. A total of 2,176 entities adopted an umbrella structure representing 13,024 sub-funds. Adding the 1,147 entities with a traditional UCI structure to that figure, a total of 14,171 fund units were active in the financial centre. As regards the impact of financial markets on the main categories of undertakings for collective investment and the net capital investment in these UCIs, the following can be said for the month of August.

During the month, markets were again focused on inflation, which remained relatively stable at high levels, raising concerns that interest rates would stay higher for longer, regardless of already deteriorating economic conditions. Weakness in the Chinese real estate sector also weighed on market sentiment resulting in an overall increase in volatility and an appreciation of the US dollar against all major currencies. Against this backdrop, equity markets fell significantly, with China and Emerging markets experiencing the largest declines. In August, the equity UCI categories registered an overall negative capital investment, mostly driven by the European, Asian and Other equities UCI categories.

Among the few Central Bank monetary policy meetings held in August, the Bank of England increased its policy rate by 25bps, a decision that was widely expected. On the opposite, the Central Bank of China lowered interest rates twice during the month, in a fight against deflation as well as poor economic perspectives notably in the real estate sector. Furthermore, regarding the US, Jerome Powell said during the annual economic symposium in Jackson Hole that the Federal Reserve will "proceed carefully as we decide whether to tighten further or, instead, to hold the policy rate constant and await further data". The above events did however not result in significant changes in yields and in credit spreads during the month.

In that context, most fixed income UCIs reported moderate performance, slightly positive, with the exception of the USD money market and the Emerging market bonds categories, which respectively registered significant positive and negative returns, both mostly explained by conversion effects. In August, fixed income UCI categories registered an overall positive net capital investment, mostly due to the USD money market UCI category.

Source: CSSF