



A Hong Kong tax treaty with Luxembourg creates an investment gateway between the East and West, write *Jeremy Choi and Kenneth Wong*

In December 2003, Hong Kong signed the first full-scope tax treaty with Belgium, one which effectively eliminated double taxation and fiscal evasion on income and capital taxes between the two sides.

The agreement was a huge milestone in the Chinese territory's tax history, as it created more investment opportunities for Hong Kong companies interested in foreign markets. Since then, Hong Kong has signed similar tax treaties with Thailand, China, Luxembourg and Vietnam.

The treaty with Luxembourg, signed on 2 November 2007, is particularly attractive in that it will establish more efficient tax structuring for investments between the East and West.

At the time this article was written, the treaty had not been put into force because the two sides have not completed the procedures on exchange of notification. Once those are done, the treaty will enter into force retroactively from 1 January 2008 in Luxembourg and from 1 April 2008 in Hong Kong.

Asian outbound investments

The tax agreement allows Asian companies to save taxes if they invest in Europe through a Hong Kong-Luxembourg holding structure. In particular, mainland Chinese companies get extra tax planning opportunities when they invest in Europe because they can take advantage of the treaty benefits under the comprehensive double tax agreement between China and Hong Kong.

Exemption of withholding tax for dividends

The most significant benefit under the agreement with Luxembourg is the withholding tax rates for dividends received by a Hong Kong company

from Luxembourg companies.

Under Luxembourg's domestic law, dividends are generally subject to a withholding tax rate of 15 percent with certain exceptions. The treaty's withholding tax rate is zero percent if the Hong Kong company directly holds 10 percent or more of the capital of the Luxembourg company, or a participation with an acquisition cost of €1.2 million or more. A withholding tax rate of 10 percent is applicable to all other cases.

The conditions for Hong Kong companies to enjoy the zero percent withholding tax rate stipulated in the double tax agreement are more liberal than the requirements set forth in a 2009 Luxembourg domestic law, which provides similar withholding tax exemptions for dividends received by corporate residents in countries that have tax treaties with Luxembourg.

Interest and royalty payments

Under the double tax agreement, interest received by a Hong Kong company from Luxembourg is not subject to withholding tax in Luxembourg, while the withholding tax rate on royalties received is 3 percent. These provisions do not provide any added tax benefit because Luxembourg currently doesn't levy any withholding tax on these payments.

Capital gains

The tax exemptions for capital gains, which are taxed as ordinary income in Luxembourg with exceptions such as where participation exemption applies, are also impressive. Under the double tax agreement, a capital gain derived by a Hong Kong company from selling shares of a Luxembourg company is tax exempt, regardless of the percentage of shareholding. This lowers the exit cost should Asian investors wish to sell their investments in Europe. The exception is for property holding companies: A Hong Kong company cannot get tax exemption on a capital gain if it sells shares of a Luxembourg property holding company that has more than 50 percent of the asset value derived from immovable property situated in Luxembourg.

Investing in Europe

The possible tax exemption for dividends and capital gains derived from disposal of shares under the double tax agreement, together with Luxembourg's extensive tax treaty network, means corporations can make use of Hong Kong and Luxembourg companies as intermediate holding companies for investing into the European Union.

In addition, partial exemption is available for income derived by a

Summary of treaty tax rates for a Hong Kong company receiving income from Luxembourg

| | Hong Kong-Luxembourg DTA rates | Non-treaty rate |
|------------------|--|-----------------|
| Dividends | <ul style="list-style-type: none"> • 0% if the Hong Kong company directly holds 10% or more of the capital of the Luxembourg company, or a participation with an acquisition cost of €1.2 million • 10% in all other cases | 15% |
| Interest | 0% | 0% |
| Royalties | Not exceeding 3% | 0% |

Luxembourg company from the use of or the right to use certain intellectual properties for domestic income tax purposes. Dividends received by a Hong Kong company from Luxembourg may also be exempt from Luxembourg withholding tax. Thus, if properly structured and carefully planned, Asian investors can use Hong Kong and Luxembourg as a conduit for licensing intellectual property to EU countries to save taxes.

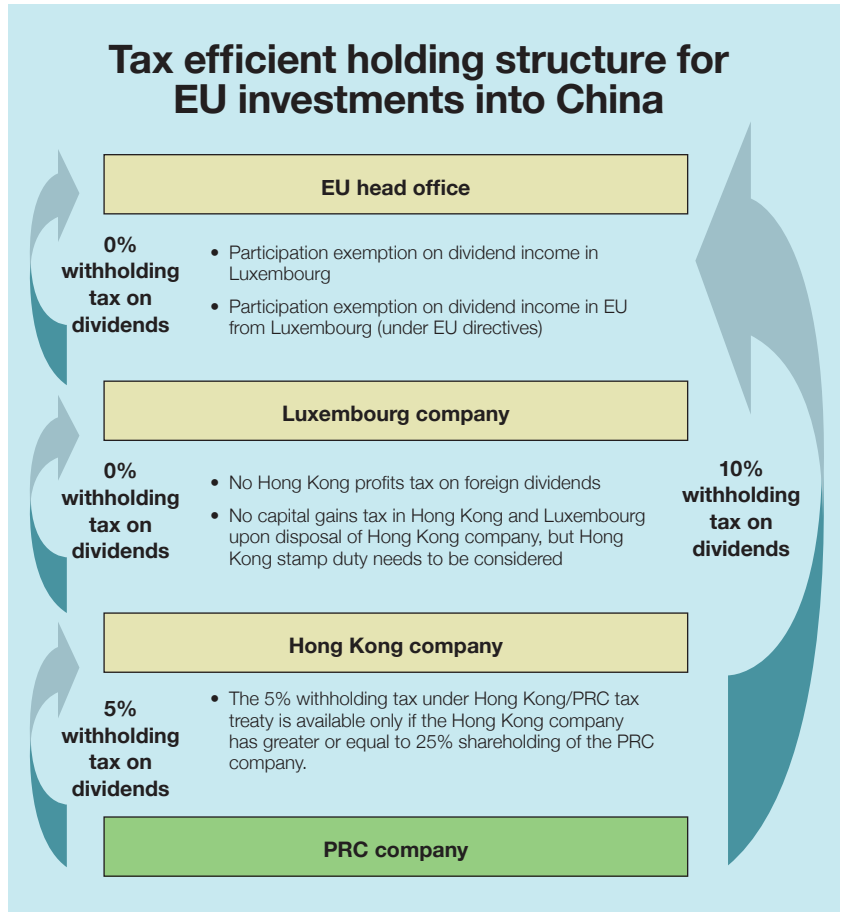
The treaty benefits are in some ways more favourable than those under the 2003 double tax agreement between Hong Kong and Belgium. For example, in order to qualify for the withholding tax exemption for dividends, a Hong Kong company has to directly hold at least 25 percent of the Belgian company paying the dividends for at least 12 consecutive months as of the dividend payment date. In addition, there is a 10 percent withholding tax on interest and a 5 percent withholding tax on royalties received from Belgium under that agreement.

Asian inbound investments

For European investors, Luxembourg can serve as a conduit for licensing intellectual property to Hong Kong.

The tax agreement between Hong Kong and Luxembourg reduces the withholding tax rate to 3 percent (instead of 4.95 percent under Hong Kong domestic law) for royalties received by a Luxembourg company from a Hong Kong company.

As Hong Kong imposes neither withholding tax on dividends paid to foreign companies nor taxes on dividends and capital gains derived from the sale of capital assets by Hong Kong companies, the Luxembourg-Hong Kong holding structure can make it more efficient – from a tax perspective – to repatriate profits and exit investments for Europeans wishing to invest in Asia.



For EU companies who want to invest in mainland China, the treaty can help them make use of Hong Kong and Luxembourg as a conduit. Under the latest China corporate income tax law, repatriations from China to European countries will generally be subject to a 10 percent withholding tax in China. The tax cost can potentially be reduced through a tax treaty between Hong Kong and the mainland, which reduces the Chinese withholding tax rate on dividends to 5 percent under certain conditions. The double tax agreement, the domestic tax laws in the respective countries and various EU tax and investment incentives available for EU countries can result in almost no or minimal tax cost for repatriations all

the way up to the EU parent company. Companies can potentially save a maximum 5 percent withholding tax on dividends.

The Hong Kong and Luxembourg double tax agreement should create a favourable tax situation for structuring investments between Luxembourg, Europe and Hong Kong. Of course, tax isn't the only element to consider; other factors such as business strategies, the legal and financial infrastructure of a given location, and the operating and maintenance costs of the treaty vehicles need to be reviewed.

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