

06. CONCLUSION

Its multinational culture, social and economical stability, legal and regulatory flexibility and - last but not least - its tax neutrality, have made Luxembourg the investors' and lenders' preferred location for setting up holding and finance companies and structuring cross border transactions.

Hong Kong has gained a similar status in Asia and offers important opportunities given its relation with mainland China.

The Treaty may be considered as a bridge between both hubs and will without doubt constitute an important tool for structuring inbound and outbound investments.

The combination of the Luxembourg Tax Treaty network, the EU parent subsidiary directive and the Luxembourg internal important participation exemption open broad horizons.

07. CONTACTS

LUXEMBOURG OFFICE

Frédéric Feyten, Head of Tax Practice
ffeyten@oostvogels.com

Stef Oostvogels, Managing Partner
soostvogels@oostvogels.com

François Pfister, Senior Partner
fpfister@oostvogels.com

Tel: +352 46 83 83

Fax: +352 46 84 84

www.oostvogels.com

LONDON OFFICE

Chokri Bouzidi, Principal
cbouzidi@oostvogels.com

Tel: +44 (0)20 7330 1111

Fax: +44 (0)20 7330 1112

www.oostvogels.com

OOSTVOGELS PFISTER FEYTEN

Established in 1999, Oostvogels Pfister Feyten is one of Luxembourg's largest independent business law firms with offices based in Luxembourg and London. We specialise exclusively in Luxembourg law.

With advisors in Luxembourg and London, our specialist tax group is complemented by around 60 lawyers from our other practice areas, including

corporate, private equity, investment funds, banking & finance, real estate, restructuring and insolvency to provide innovative and creative thinking to our clients projects. Today, we advise an international clientele of multi-national corporate groups, leading banking and finance institutions, private equity houses and investment funds as well as high net worth individuals.

LUXEMBOURG HONG KONG TAX TREATY

01. INTRODUCTION

On April 4, 2008 the Luxembourg Government lodged bill n°5862 with the Parliament. The bill aims to approve the treaty between the Grand Duchy of Luxembourg and the Hong Kong Special Administrative Region of the People's Republic of China for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, which was signed in Hong Kong on November 2, 2007. On June 3, 2008, the Luxembourg Council of State finalised its opinion on the ratification bill and it is expected that Parliament will pass the bill soon.

This new treaty ('The Treaty') is of paramount importance for international business and should offer tentaculous tax planning opportunities for investments to and from Asia, through Luxembourg and Hong Kong. Until now, only a limited number of jurisdictions have signed a comprehensive double taxation treaty with Hong Kong, specifically, China, Thailand, Belgium and now Luxembourg. The Treaty may be considered as being highly attractive in many respects. As the 1994 Luxembourg – China treaty does not apply to the Hong Kong territory, it has become essential to complete Luxembourg's already extensive tax treaty network with a new treaty linking these two major financial and commercial hubs on the crossroads of Europe and Asia.

02. HONG KONG, A SPECIAL ADMINISTRATIVE REGION

Formerly a dependent territory of the United Kingdom, on July 1, 2007, Hong Kong became a 'Special Administrative Region' of the Republic of China (hereinafter 'PRC'), in accordance with the terms of the Sino-British Joint Declaration signed in December 1984.

In accordance with one of the main principles of the regulations of the Special Administrative Regions ('SAR'), "one country, two systems", Hong Kong has maintained its political, legal, and economic independence from the PRC. Therefore, the bilateral double tax treaties signed by Hong Kong with other countries are fully independent from those which are signed by PRC. Reversely, PRC's bilateral double tax treaties with other jurisdictions are not binding on Hong Kong. ■



03. SALIENT ASPECTS OF THE TAX SYSTEMS

3.1 WITH RESPECT TO HONG KONG

3.1.1. CORPORATE INCOME TAX

Hong Kong does not have an income tax system exclusively applicable to companies. On the other hand, each person (individual, company or branch) is subject to a (schedular) profit tax on profits arising in relation to a commercial or professional activity exercised in Hong Kong, regardless of whether or not such a person is tax resident there. Companies are taxed at a rate of 17.5% and individuals at a rate of 16%. The Hong Kong tax system is based on the principle of territoriality whereby only income from Hong Kong sources is subject to tax in Hong Kong. Income deriving from activities deployed outside the territory of Hong Kong will not be included in the taxable basis.

Real property income is subject to a 16% property tax based on rental income, after a 20% deduction for repairs and maintenance.

In Hong Kong, neither inbound nor outbound dividends nor long-term capital gains are subject to tax.

3.1.2. WEALTH TAX

There is no wealth tax in Hong Kong.

3.1.3. WAGE TAX

Hong Kong does not levy a tax on income as such, however, it does tax income derived from a salaried occupation. The progressive tax rates are applicable according to four tax brackets: 2% on the first HKD 35,000, 7% on the second bracket of HKD 35,000, 12% on the third bracket of HKD 35,000, and 17% on the exceeding amount. The total tax rate applicable to salaries may not exceed a standard tax rate of 16%.

3.1.4. VAT

Hong Kong does not levy any VAT.

3.2. WITH RESPECT TO LUXEMBOURG

3.2.1. PARTICIPATION EXEMPTION REGIME

The Luxembourg participation exemption regime is a corner-stone for corporate and tax structuring on the basis of the Treaty.

The Luxembourg important participation exemption provided by Luxembourg income tax law applies to profit distribution and capital gains deriving from participations held in (inter alia) a qualifying non resident subsidiary provided that such non resident subsidiary is subject to a corporate income tax in its country of residence which is comparable to Luxembourg corporate income tax. There are special rules for companies located in EU Member States. However, for companies located outside the EU, the Luxembourg tax authorities consider that a foreign corporate income tax is considered to be comparable to Luxembourg *impôt sur le revenu des collectivités* to the extent that (a) the taxation is not optional, (b) the nominal tax rate is not less than half of the Luxembourg corporate income tax rate (this in fact means that the foreign tax rate may not be less than 11% (this rate might be reduced to 10.5% when the 2009 budget tax provisions will be approved)) and (c) that the rules and criteria to determine the taxable basis are similar to those applicable under Luxembourg law. ▶

In the context of a Hong Kong subsidiary held by a Luxembourg resident company, special attention will be required as to whether Hong Kong's 17.5% income tax levied only on profits from commercial or professional activities carried out in Hong Kong will be considered as comparable to Luxembourg corporate tax. Such doubts, if any, should be dissipated through an advanced tax ruling from the Luxembourg tax authorities confirming the applicability of the Luxembourg participation exemption to profits distribution and capital gains derived by the Luxembourg resident parent company in connection with its shareholding in its Hong Kong subsidiary.

Comparatively, it is worth noticing that the question of the comparable-tax test also arises in Belgium with respect to profits derived by a Belgian parent company from a subsidiary located in Hong Kong. The Belgian Ruling Commission has ruled on November 7, 2006 and on August 7, 2007 that income deriving from a Hong Kong subsidiary does qualify for the tax exemption in the hands of the Belgian parent considering that (a) Hong Kong corporate income tax rate is 17% and (b) the principle of territoriality applied under Hong Kong tax rules does not make the Hong Kong tax system substantially more advantageous.

A similar approach can be expected from the Luxembourg tax authorities provided that there are no transfer pricing issues, there is no fraud or abusive structures and that there is a proportional substance. Indeed, the Luxembourg Government specifies in its comments that a person will not automatically be excluded from the application of

the Treaty on the mere grounds that it is subject to a tax system based on the principle of territoriality. The place of effective management test would, however, be of material importance in order to determine whether or not the subsidiary will be considered as a resident of Hong Kong.

3.2.2. DIVIDEND WITHHOLDING TAX

The 15% dividend withholding tax is reduced significantly under most tax treaties and would be brought to 0% under the Treaty. Moreover, the EU Parent Subsidiary Directive permits – subject to certain conditions – dividends to flow between resident companies of EU Member States tax free.

Bill n°5924 that was lodged on October 1, 2008 provides for a reduction of the Luxembourg withholding tax rate to 0% for dividends paid to a parent company which is considered tax resident in a country with which Luxembourg has concluded a tax treaty, provided that such parent company is subject to a tax which is comparable to Luxembourg corporate income tax (see Section 3.2.1 above) and which holds (or commits itself to continue to hold) a shareholding of at least 10% or of an acquisition value of at least EUR 1,200,000 for a period of at least twelve months. Once voted, this exemption will increase the structuring possibilities through Luxembourg, including those structures in combination with Hong Kong. ▶

04. GATEWAY TO ASIA

The Treaty is expected to offer a gateway to Asia in general and to China in particular. US or EU based investors dispose of several alternatives to structure and optimise their investments tax efficiently.

For the (final or partial) exit as well as the repatriation of funds from Luxembourg to the investors, the usual techniques and structures can be used. Where the investors are tax resident in a country which has a tax treaty with Luxembourg, the profit repatriation from Luxembourg would be even more simplified as of 2009, once the announced abolishment of withholding tax on profit distribution comes into effect (see Section 3.2.2. above).

4.1 DIVIDEND FLOWS

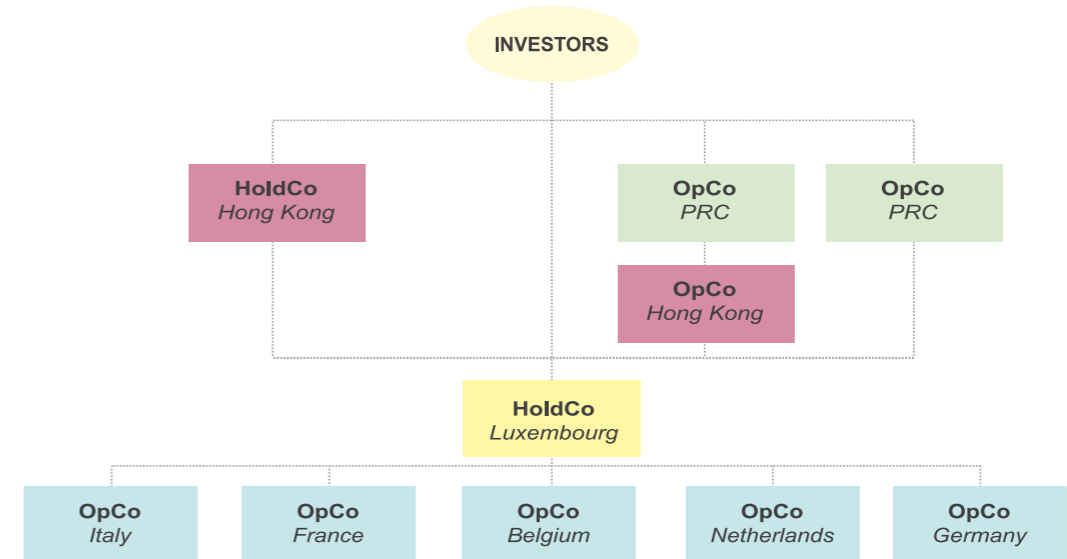
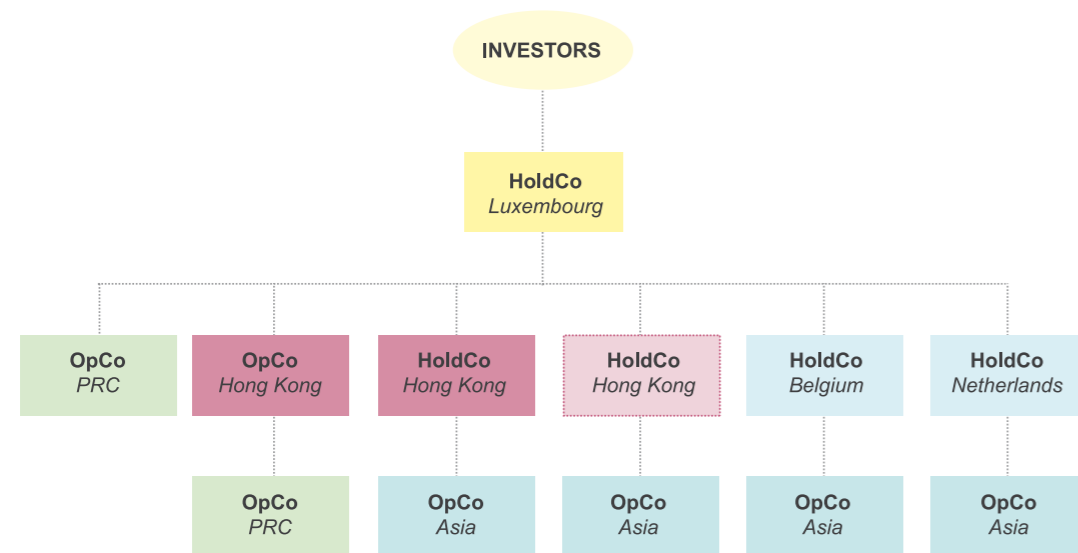
The provisions of the Treaty in combination with the favourable domestic tax rules of Luxembourg and Hong Kong concerning dividend taxation should provide a secure yet straightforward tax planning tool for investors either through a Luxembourg parent holding a Hong Kong subsidiary or vice versa.

Dividends distributed by a Hong Kong subsidiary to its Luxembourg parent will not be subject to Hong Kong withholding tax to the extent the Luxembourg parent holds at least 10% or a participation representing an acquisition cost of at least EUR 1,200,000 in its subsidiary. In all other cases, the withholding tax may not exceed 10%. It is important to note, however, that under its current legislation, Hong Kong does not levy any withholding tax on dividends distributed. Should this change in the future, the Treaty would offer protection. ▶

The Luxembourg parent can upstream the funds to its shareholders either by way of dividend distribution (possible with no tax leakage – see Section 3.2.2 above), by way of liquidation proceeds (also without tax leakage) or by using other more sophisticated structures. Luxembourg can cater tax efficient solutions for investors from different jurisdictions, including off-shore territories.

In the reverse situation of profit distributions by a Luxembourg subsidiary to a parent company situated in Hong Kong, a full relief from withholding tax should be available subject to similar conditions as those mentioned above either on the basis of the Treaty or the basis of Luxembourg domestic law; the conditions required for the Treaty withholding tax relief being less onerous

than those required under domestic law (i.e. absence of the requirement of a holding period). Such distributions should not be subject to any income tax in Hong Kong (pursuant to the territoriality principle) and should be able to be distributed onto foreign investors, wherever resident or established, including in off-shore jurisdictions, withholding tax free. Following this route, profits should be able to flow fully tax neutral from the source countries, through Luxembourg and Hong Kong to the investors. ▶



4.2 INTEREST

According to the Treaty, interest income is taxable only in the State of residence of the beneficiary. Therefore, interest income should be able to flow between Luxembourg and Hong Kong withholding tax free, in Luxembourg on the basis of Luxembourg domestic law and the Treaty, and in Hong Kong on the basis of the Treaty.

Other treaties such as the Belgium-Hong Kong treaty are less advantageous and provide for a withholding tax of 10% on the gross amount of interest paid by a resident of a treaty country to a resident of the other country, save interest on commercial debts-claims, debt-claims or loans of any nature (not represented by bearer instruments) paid to banking enterprises, deposits made by an enterprise with a banking enterprise and, on certain loans related to the Hong Kong or Belgian governments.

4.3 MOST FAVOURABLE WITHHOLDING TAX ON ROYALTIES

Royalties are taxable only in the State of residence of the beneficiary but may be subject to a withholding tax of maximum 3% of their gross amount in the State of source. None of the tax treaties concluded by Hong Kong up to the date of signature of its treaty with Luxembourg provides for a more favourable royalties withholding tax rate. It is also to be noted that the concept of royalties as defined in the Treaty includes, among other things, payments made for the use of or the right to use industrial, commercial or scientific equipment. Such provisions would have been included in the Treaty at the explicit request of Hong Kong in order to be able to tax, albeit at a reduced (3%) rate, remunerations paid from Hong Kong sources in connection with the leasing of industrial, commercial and scientific equipment (including the leasing of containers) which would have otherwise escaped taxation in Hong Kong in the absence of a permanent establishment that a Luxembourg resident may have in Hong Kong to which the remunerations may be attributed. ▶

4.4 CAPITAL GAINS

The capital gains provisions of the Treaty are in line with the provisions of the OECD Model Convention. Gains realised on the sale of assets other than (a) real property, (b) permanent establishments or assets of permanent establishments, (c) ships or aircrafts, or (d) shares in real property companies, are taxable only in the State where the seller is resident. On the basis of these provisions, therefore, capital gains realised on the sale by a Luxembourg parent company of its shares in a Hong Kong subsidiary will be taxable only in Luxembourg. Pursuant to Luxembourg domestic law, however, such gains should benefit from a full tax exemption if the conditions required for the domestic participation exemption regime are met (see Section 3.2.1. above)

4.5 REAL PROPERTY

In line with the OECD Model Convention, income and gains derived from real property are taxable only in the Contracting State where the real property is situated. The same applies to gains on the sale of shares in real estate companies (companies whose assets consist directly or indirectly of more than 50% real estate) except if (a) the shares are listed or (b) are alienated as a result of a reorganisation, merger or demerger, or (c) the company generates more than 50% of its value from property in which it exercises its activities.

4.6 NO EXCLUSIONS

The Treaty does not exclude the Family Asset Management Companies (*sociétés de gestion du patrimoine familial*) from its scope of application. The Family Asset Management Company was introduced in early 2007 to replace the abolished Holding 1929 tax regime. Provided certain conditions are met, these entities are fully exempt from tax in Luxembourg. If it is confirmed that the benefits of the Treaty extend to Family Asset Management Companies, interesting tax structuring opportunities may become available.

The Treaty does also not expressly exclude the Luxembourg Undertakings for Collective Investments from its scope, as is the case under the Luxembourg-China treaty.

05. ENTRY INTO FORCE

The Treaty would enter into force after the exchange between Luxembourg and Hong Kong of the ratification instruments. However, its provision will take effect and apply retroactively to taxable years commencing on or after January 1, 2008 as far as Hong Kong is concerned. In Luxembourg, the Treaty will also have a retroactive effect and will apply to taxes due on or after January 1, 2008 as far as income taxes and net wealth tax are concerned and to income attributed on after the same date as to withholding taxes. ▶

