Analysis: Luxembourg – China Income and Capital Treaty

See treaty text

Type of treaty: Income and Capital
Based on the OECD Model Treaty
Signed: March 12, 1994
Entry into force: July 28, 1995
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Article 1 Personal Scope

See treaty text

This article defines the personal scope of the Treaty: The persons that are resident of one or both States, not the nationals of these States. The nationality is irrelevant unlike in article 25 (non-discrimination) where the residency is irrelevant. The term "persons" and "resident" are further defined in articles 3 and 4.

Luxembourg and China agreed that the Luxembourg investment funds created as Open ended Investment Scheme (Societe d'investissement a capital variable - SICAV) / Closed ended Investment Scheme (Societe d'investissement a capital fixe - SICAF) benefit from the Treaty.

Article 2 Taxes Covered

See treaty text

Future identical or similar taxes which are levied together or in replacement with the taxes listed in the Treaty are covered by the Treaty. There is an obligation of both States to inform the other Contracting State of significant legislative changes.

In detail, the taxes covered are:

Luxembourg

• The income tax on individuals (l'impot sur le revenu des personnes physiques)
• The income tax on bodies corporate (l'impot sur le revenu des collectivites)
• The special tax on directors' fees (l'impot special sur les tantiemes)
• The capital tax (l'impot sur la fortune) • The municipal business tax (l'impot commercial communal)

China

• The individual income tax
• The income tax for enterprises with foreign investment and foreign enterprises
• The local income tax

Article 3 General Definitions

See treaty text

Luxembourg: The territory of the Grand-Duchy of Luxembourg

China: The territory of People's Republic of China, including its territorial sea, in which the Chinese laws relating to taxation apply, and any area beyond its territorial sea, within which the People's Republic of China has sovereign rights of exploration for and exploitation of resources of the seabed and its subsoil and superjacent water resources in accordance with international law.

Person: includes an individual, a company and any other body of persons;

Company: any body corporate or any entity which is treated as a body corporate for tax purposes

Nationals: all individuals possessing the nationality of a Contracting State and all juridical persons created or organised under the laws of that Contracting State, as well as organisations without juridical personality treated for tax purposes as juridical persons created or organised under the laws of that Contracting State.

For the application of the Treaty by Contracting State any word not defined otherwise has the meaning given by the tax laws of that State with a preeminence given to the meaning by the tax laws of that State.

Article 4 Resident

See treaty text

Resident: any "person" who, according to the legislation of a Contracting State, is liable to tax in that State by reason of his domicile, residence, place of head office (place of effective management) or any other criterion of a similar nature.

This includes any entity listed in article 159 L.I.R. which has its statutory seat or central administration in Luxembourg. In case of dual residences of individuals, the usual tiebreaker tests apply in ranking order:

• The State where the individual has a permanent home available,
• The State where the individual has the closer personal and economic relations (center of vital interests),
• The State where the individual has an habitual abode,
• The State of which the individual is a national,
• In case of dual nationality of the Contracting States or in the absence of such nationality, the issue will be settled by mutual agreement by the Competent Authorities of the Contracting States.
For a person that is not an individual the dual resident tiebreaker is the place of head office (place of effective management).

China

Companies incorporated in China are considered tax resident. Additionally, under the Corporate Income Tax Law which became effective as of January 1, 2008, China now determines company residence according to the place of effective management. This is interpreted as the exercise of the overall management and control of production, business, employees, finance and assets of a company (Articles 2 and 3 of the CITL). Thus day-to-day control as well as strategic management must be considered and the definition is very broad.

Article 5 Permanent Establishment

See treaty text

The Treaty follows article 5 OECD MTC, first giving a general definition, then listing various forms of places and then detailing the exclusions.
A building or construction site becomes a permanent establishment only if it lasts for more than six months. It is worthwhile noting the extended definitions of such site provided by the 2010 OECD Commentary in its note 17 to article 5, paragraph 3.
In line with the UN MTC the Treaty also considers as a permanent establishment the furnishing of services, including consultancy services, by an enterprise of a Contracting State through employees or other personnel engaged in the other Contracting State, provided that such activities continue for the same project or a connected project for a period or periods aggregating more than 6 months within any 12-month period.
The Treaty addresses and exempts the maintenance of a fixed place of business solely for any combination of excluded activities.
When a person acting on behalf of an enterprise of a Contracting State has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that resident is deemed to have a permanent establishment in that other State, unless the activities of the person are limited to the purchase of goods or merchandise for the enterprise. This addresses the dependant agent or employee of an enterprise. There is no definition of "habitually".
Where the agent is an independent agent (e.g. a broker, commissionaire or other independent agent acting in the ordinary course of his business) the presence of the agent will not give rise to a permanent establishment unless this agent work wholly or almost wholly for his principal, in which case the agent will no longer be considered as independent.
The fact that a company has a subsidiary or a parent in the other Contracting State does not mean that the subsidiary or parent is a permanent establishment of that company, even when it acts in the other Contracting State through a permanent establishment or otherwise.

Article 6 Income from Immovable Property

See treaty text

The general rule is that income derived by a resident of a Contracting State from immovable property in the Other State may be taxed in that Source State. This covers income from agriculture and forestry.
The term of "immovable property" is defined by the domestic tax laws of the State where the property is situated. Its definition follows the OECD MTC wording. It clarifies that fees paid for the exploitation of natural resources are always income from immovable property and that ships and aircrafts are not considered to be immovable property, unlike their accounting treatment.
This Article also applies to income from an immovable property of an enterprise or used for the performance of independent personal services.
Luxembourg extends the definition also to the capital gain and revenue from an ancillary agricultural and forestry activity.

Article 7 Business Profits

See treaty text

Business profits are taxable in the Residency State only. If income is derived through a permanent establishment in the other Contracting State, then that Source State can only tax the portion allocated to the permanent establishment located there.
Business profits should be allocated to a permanent establishment on an arm's length basis as if it were a distinct and separate enterprise.
Expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses, whether incurred in the State in which the permanent establishment is situated or elsewhere, are allowed as deductible expenses.
The Treaty foresees that if it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, a Contracting State may use that method (in accordance with the principles of this article)
Purchasing activities only do not give rise to a profit allocation.
The profits of a permanent establishment have to be established in a consistent manner every year unless good and sufficient reasons call for a deviation.

Article 8 Shipping and Air Transport

See treaty text

This provision which relates to shipping and air transport in international traffic deviates from the provision of article 8 of the OECD MTC by not emphasizing the focus on the effective management of the companies, but their residency.

Article 9 Associated Enterprises

See treaty text

This article addresses the OECD standards on transfer pricing. Associated Enterprises must adopt the arm's length principle in their commercial and financial transactions with each other, and to the extent that they do not, a Contracting State may adjust the taxable profits accordingly.
In case of a tax audit adjustment by one State then the State will make a corresponding adjustment to the amount of tax it has charged on that same income.

Article 10 Dividends

See treaty text

The treaty follows the OECD MTC but deviates in some points.
There is a requirement for the recipient to be the beneficial owner. As a rule, the Treaty provides for taxation of the dividends paid in the Residency State of the recipient with the possibility of the Source State to levy a withholding tax of maximum

- 5% if the recipient is the beneficial owner is a company (not a partnership) that controls directly at least 25% of the voting power of the paying company
- 10% in the other cases.

The term “dividends” means income from shares, or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident. Profits distributed by an enterprise liable in China to the income tax for enterprises with foreign investment to a resident of Luxembourg are deemed to be dividends.
The normal Luxembourg withholding tax rate on dividends is 15%.

China

As per Article 4 of CITL which came into effect on January 1, 2008: 10% withholding tax. This replaces the previous exemption from withholding tax for dividends.
If a company becomes resident of Luxembourg or China for the principal purpose of enjoying benefits under this Treaty, the company does not get the benefit of this Article (see Article 4.5).

Article 11 Interest

See treaty text

The Residency State of the recipient is entitled to tax interest income but the Source State may tax the income too.
There is a maximum withholding tax rate of 10% in the Source State under this Treaty. However, this withholding tax only applies to interest paid to beneficial owners of the interest that are resident in the Other State.
Interest from indebtedness paid to the Government of the Other State is taxable in the Residency State. The Treaty defines Government as the Chinese state banks and the Luxembourg National Credit and Investment Corporation (la Societe Nationale de Credit et d'Investissement). This is also valid in case of governmentally guaranteed or insured indebtness.

Late payment interest penalties are taxable in the Source State.
Interest attributable to permanent establishments are taxable under articles 7 or 14 of the Treaty.
Similar to the OECD MTC the Treaty provides that when there is a special relationship between the debtor and the creditor of the interest or between them and a third party, and therefore the interest paid exceeds what the parties would have agreed without that special relationship, the treaty will apply only to this amount and the excess will be taxed according to domestic legislation of the Contracting States taking into account the other articles of this treaty.

China

Withholding tax of 10%, unless paid in connection with a permanent establishment which the recipient has in China. Interest on certain governmental loans may be exempt.
If a company becomes resident of Luxembourg or China for the principal purpose of enjoying benefits under this Treaty, the company does not get the benefit of this Article (see Article 4.5).

Article 12 Royalties

See treaty text

For this article, the Treaty deviates from the OECD MTC. The Treaty allocates the taxation of royalties to the Residency State of the beneficial owner but allows for source taxation.
For payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films and films or tapes for radio or television broadcasting, any patent, knowhow, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, the maximum withholding tax is 10% of the gross amount received.
For payments of any kind received as a consideration for the use of, or the right to use industrial, commercial or scientific equipment, the maximum withholding tax is 10% of 60% of the gross amount received.
In case the royalties are received by a permanent establishment or a fixed base used for independent services, the taxation right reverts to the Residency State of the permanent establishment or fixed base under articles 7 and 14.
Similar to the OECD MTC the Treaty provides that when there is a special relationship between the debtor and the creditor of the royalties or between them and a third party, and therefore the paid royalties exceed what the parties would have agreed without that special relationship, the treaty will apply only to this amount and the excess will be taxed according to domestic legislation of the Contracting States taking into account the other articles of this treaty.

China

Withholding tax at a rate of 10%.
If a company becomes resident of Luxembourg or China for the principal purpose of enjoying benefits under this Treaty, the company does not get the benefit of this Article (see Article 4.5).

Article 13 Capital Gains

See treaty text

This article also differs from the OECD MTC.
Gains derived by a resident of a Contracting State from the alienation of immovable property situated in the Other Contracting State may be taxed in that Other State. In other words, the Source State where the property is situated may tax the capital gain.
Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State or of the fixed base which a resident of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base may be taxed in the Source State.
Gains from ships and aircraft operated in international traffic and related movable property are taxed in the Residency State of the owner.
Capital gains from the alienation of shares when the underlying value is derived from real estate may be taxed in the Source State.
Gains from the alienation of shares representing a participation of at least 25% in a company which is a resident of a Contracting State may be taxed in that Contracting State.
Luxembourg domestic law taxes capital gains from the alienation of shares by a non-resident only when the shareholding exceeds 25% and the time between the acquisition and the sale is less than 6 months. Once the six months passed in order to be exempt, the non-resident seller has to be a former resident for at least 15 years and become non-resident less than 5 years before the alienation.
All other capital gains are taxable in the Residency State.

China
Non-residents are taxed on gains on the disposal of Chinese property via a withholding tax.

Article 14 Independent Personal Services

See treaty text

This Article provides that such income is taxable in the Residency State only but where a resident of a Contracting State has a "fixed base" in the other State, income in respect of professional services attributable to that fixed base may only be taxed in the Source State. In the absence of a fixed base, but in case of a stay exceeding in the aggregate 183 days in a calendar year, the corresponding income is taxable in the Source State.
This treatment applies to the independent scientific, artistic, literary, educational or pedagogic activities and independent activities of physicians, lawyers, engineers, architects, dentists and accountants.
In case of a fixed base Luxembourg applies a 10% withholding tax.

Article 15 Dependent Personal Services

See treaty text

Following article 15 of the OECD MTC salaries and wages and similar compensation from dependent work are taxable in the Residency State unless the activities are performed in the other State in which case the Source State taxes the compensation. Directors, pensions, Government Services and students are dealt with under articles 16, 18, 19, 20 and 21 of this Treaty.
There are exceptions to the Source State taxation:
• The recipient is present in the Source State for a period of no more than 183 days in the calendar year concerned and
• The compensation is paid by or on behalf of an employer that is not a resident in the employee's Source State; and
• The compensation is not borne by a permanent establishment or a fixed base which the employer has in the Source State.
Compensation for services rendered on board of a ship or an aircraft operated in international traffic are taxed in the Residency State of the company.
China
The extent of the taxation of expatriates depends on whether the stay is more than a year and whether it is more or less than five years. If the stay is for less than 90 days, then Chinese source income is taxable, except that employment income not borne by Chinese employer is not taxed. (This corresponds to the rules set out in the Treaty, where the period is 183 days.) If the stay is for more than 90 days but less than a year, then Chinese source income, but not foreign income, is taxed in China. If the stay is for less than five years, then foreign income is usually exempt from Chinese tax. Only for stays of more than five years does full Chinese taxation apply.
Employer provided accommodation, travelling expenses, removal costs, and general household costs for expatriates are tax-free.
China also permits an enhanced personal tax allowance.

Article 16 Directors' Fee

See treaty text

These fees may only be taxed in the Source State. Luxembourg applies a 20% withholding tax.
Remuneration received in a non-supervisory capacity (daily general management, technical, commercial or financial) is taxable as income from employment (Article 15 of this Treaty). For example the compensation received by the Managing Director for its day-to-day management falls under article 15.
For Luxembourg this article is an exception to the domestic legislation which taxes these activities as income from independent services.

Article 17 Artistes and Sportspersons

See treaty text

Income derived by a resident of a Contracting State as an entertainer, a theatre, a motion picture, a radio or a television artiste or a musician, or as a sportsman, from their personal activities exercised in the other Contracting State, may be taxed in Source State.
This also applies when the compensation received by a performing artist or a sportsman are attributed to another person and the artist or sportsperson participates in the profits of such person.
The Treaty adds a third paragraph not provided for in the OECD MTC and exempts income derived by entertainers or athletes who are residents of a Contracting State from the activities exercised in the

other Contracting State under a plan of cultural exchange between the Governments of both Contracting States.
Luxembourg applies a 10% withholding tax.

Article 18 Pensions

See treaty text

Subject to the provisions of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment are taxable only in the Residency State
Pensions and other payments made under the social security legislation of a Contracting State are taxable only in the Source State.

Article 19 Government Service

See treaty text

Salaries, other than pensions, paid by a Contracting State or its political subdivisions are taxable only in the Source State.
Exceptions to this article are remunerations and pensions for commercial activities of a Contracting State or its subdivisions or the abovementioned bodies.

Article 20 Teachers and Researchers

See treaty text

The teachers and researchers are taxable in their Residency State for the first three years after starting work in the Source State.

Article 21 Students and Trainees

See treaty text

Payments which students or business apprentices who are present in the visited State solely for the purpose of their education or training, receive for the purpose of their maintenance, education or training are not taxed in the visited State, provided the payments arise from sources outside that State. This also applies to grants, scholarships or awards received or income from personal services performed to the extent the income is necessary for their stay.

Article 22 Other Income

See treaty text

Any income not dealt with in the preceding Articles is taxable only in the Residency State.

Article 23 Capital

See treaty text

As a rule elements of capital of a resident are taxed by the Residency State of the owner. They may be taxed by the Source State in two cases:

- Immovable property: location
- Business property of a permanent establishment or of a fixed base: location

Ships and airplanes in international traffic are taxed in the Residency State of the operator.
Luxembourg has abolished the Capital Tax for individuals.

Article 24 Methods for the Elimination of Double Taxation

See treaty text

This article sets the principle that double taxation should be avoided and that income or wealth taxed in one State should not be taxed in the other State, even through a withholding tax. Because the tax laws of Luxembourg and China are so different, the treaty negotiators agreed to have a separate paragraph for each State.

Luxembourg

Luxembourg uses the exemption method with progression for the avoidance of double taxation thus taking into account any exempted income or element of wealth under this Treaty in determining the rate of tax to be applied to the income or wealth remaining taxable in Luxembourg.
For withholding taxes paid in China (articles 10, 11, 12, 13) Luxembourg applies the credit method, but limits the credit to the fraction that is allocated to these categories of income compared to the total taxable income and to the amount of tax that would be due if this income was paid to a Chinese resident. The excess tax is deductible from income. The tax paid in China shall be deemed to include the amount of tax which would have been paid in China if it had not been exempted or reduced in accordance with the laws and regulations of China designated to promote economic development in China. For 15 years after the entry into force of the Treaty, the amount of tax deemed to have been paid in China shall be:
(i) 10% of the gross amount of dividends
(ii) 10% of the gross amount of interest; and
(iii) 10% of the amount of royalties.

As an exception, dividends of a Chinese resident stock company received by a Luxembourg company with a direct shareholding of at least 10% or a purchase price of at least EUR1.239m are exempt from Luxembourg income tax (exemption with progression) and the shares are exempt from net worth tax.

China

China uses the credit method. In case of a dividend received by a Chinese company from a 10% plus Luxembourg resident subsidiary China grants a credit for the underlying corporate income tax paid by the subsidiary.

Article 25 Non-Discrimination

See treaty text

This article follows the OECD MTC provisions that nationals of the Contracting States shall not be subjected in the Other State to any taxation or any requirement which is different or more burdensome than the taxation and connected requirements to which nationals of the Other State in the same circumstances are or may be subjected. For this article to be applicable residency is indifferent; the nationals of either State may not even be resident in Luxembourg or China.

Stateless persons are not mentioned due to a lack of interest of the two Contracting States.

The non-discrimination principle also applies to permanent establishments, enterprises and subsidiaries.

Taxation in this article means any tax whatever its nature or name.

Article 26 Mutual Agreement Procedure

See treaty text

Where a resident considers that the actions of one or both of the States result or will result in double taxation inconsistent with the provisions of this Treaty, it may present its case to the Competent Authority of its Residency State, irrespective of the remedies provided by domestic law.

The two Competent Authorities will try to resolve the double taxation by mutual agreement. They may communicate directly. This removes the need for the Competent Authorities in each State to go through diplomatic channels: They may simply contact each other directly eventually setting up a commission to settle the case. The mutual agreement procedure is commonly used to decide matters concerning income and expense allocations and transfer pricing.

There is a three year time limit set for the taxpayer to present the case.

Article 27 Exchange of Information

See treaty text

The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Treaty or of the domestic laws concerning any taxes that are not contrary to this Treaty.

Any information received under this article by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to taxes, or the oversight of the above.

Any information obtained may be used also by a Contracting State for other purposes, if according to the legislation of both Contracting States such information can be used for such purposes and if the competent authorities of the information providing State agree.

The Article includes the usual limits:

• Carry out administrative measures at variance with the laws or administrative practices of either State;

• Supply information which is not obtainable under the laws of either State; and

• Supply information which would disclose any trade, business, industrial commercial or professional secret of trade process, or information the disclosure of which would be contrary to public policy.

Article 28 Diplomatic Agents and Consular Officers

See treaty text

The Treaty affirms fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

Article 29 Entry into Force

See treaty text

The article relates to the entry into force.

Article 30 Termination

See treaty text

This Treaty remains in force for an initial period of five years and indefinitely thereafter as long as it is not terminated by one of the two States and its termination is subject to a notice period of at least six months before the end of a calendar year.