BSP BONN STEICHEN & PARTNERS

Avocats
2, rue Peternelchen | Immeuble C2
L-2370 Howald | Luxembourg

T. +352 26025-1 | F. +352 26025-999
mail@bsp.lu | www.bsp.lu

Luxembourg – Europe's Foremost RMB Hub

Laurent Lazard and Helen Haijing Liu of Bonn Steichen & Partners explain the role of Luxembourg in the internationalisation of the renminbi and the benefits of structuring investments through the country

1. WHAT ARE THE CONTINUING EFFORTS TO INTERNATIONALISE RENMINBI? WHAT IS THE ROLE OF LUXEMBOURG IN THIS PROCESS?

On 28 June 2014, a memorandum of understanding (**MoU**) on renminbi (**RMB**) clearing arrangements in Luxembourg was signed between the central bank of Luxembourg (*Banque centrale du Luxembourg*) (**BCL**) and China's central bank, People's Bank of China (**PBoC**). In September, Industrial and Commercial Bank of China (**ICBC**) was designated as the RMB clearing bank in Luxembourg. This evidences a further step in China's efforts to internationalise RMB.

Currently, Luxembourg is the leading centre for RMB business in the euro zone. As of the first quarter of 2014, it harbours around 79.4 billion RMB in deposits, a 24% increase from the last quarter of 2013. It currently hosts the European headquarters of China's three leading banks, namely Bank of China, China Construction Bank and ICBC. It is expected that Chinese Merchants Bank, Bank of Communications and Agricultural Bank of China are going to set up in Luxembourg as well.

Luxembourg endeavours to play a more important role in the internationalisation of RMB. After the signing of the MoU, the Ministry of Finance of Luxembourg led a delegation of 70 top executives from the financial and related sectors to China to further reinforce the financial cooperation between China and Luxembourg. It was during this visit that announcements were made on the opening of branches of Alipay, China Merchant's Bank and Agricultural Bank of China in Luxembourg. Indeed, according to the latest SWIFT (Society for Worldwide Interbank Financial Telecommunication) data, Luxembourg ranks second as a "true offshore" RMB centre behind Singapore and before London.

2. CHINA'S STATE ADMINISTRATION OF FOREIGN EXCHANGE HAS RELAXED FOREIGN EXCHANGE CONTROL ON ROUND-TRIP INVESTMENTS UTILISING SPECIAL PURPOSE VEHICLES. HOW DO THE NEW RULES FACILITATE TRADE AND INVESTMENT PROCESSES?

On 14 July 2014, China's State Administration of Foreign Exchange (**SAFE**) promulgated the Circular on the "Management of Offshore Investment and Financing and Round-Trip

Investment by Domestic Residents through Special Purpose Vehicles (**SPVs**)" (**Circular 37**) to simplify the approval process and promote the cross-border investment, supporting China's "going-out" strategy.

Circular 37 facilitates China's outbound investment processes in the following three ways:

i. it expressly allows outward funds flow. Domestic residents may purchase and remit foreign exchange out of China to establish an SPV, repurchase or delist shares of an SPV based on actual and reasonable needs. Domestic entities under direct or indirect control of a domestic resident may also finance their registered SPVs. These are very significant and positive developments as they indicate that the government of the People's Republic of China (**PRC**) is becoming increasingly flexible in allowing outbound funds flow by domestic institutions and individuals;

ii. it expands the definition of SPVs. Circular 37 expands the purpose of SPVs to include offshore investments in addition to financing. It also allows resident individuals to make foreign exchange registration for their offshore investments even when such foreign investments do not involve any PRC assets or interests;

iii. no mandatory requirement for repatriation of profits onshore. Circular 37 does not require mandatory repatriation of all profits, dividends and proceeds arising from the disposal of interests in an SPV within 180 days of the receipt of such profits, dividends or proceeds (as required under the previous Circular 75).

The promulgation of Circular 37 is in line with the recent developments on the internationalisation of RMB, i.e. the aforesaid MoU signed between China and Luxembourg. With the future establishment of a RMB clearing bank in Luxembourg and the promotion of outbound investment domestically in China, the use of RMB by businesses and financial institutions for cross-border transactions will be enlarged, thus promoting trade and investment in Luxembourg.

3. THE NATIONAL DEVELOPMENT AND REFORM COMMISSION OF CHINA PUBLISHED A NEW REPORT ON AUGUST 5 2014. WHAT IMPACT DOES IT HAVE ON CHINESE OUTBOUND INVESTMENTS?

On August 5 2014, the National Development and Reform Commission of China (**NDRC)** published a report on outbound investment. According to the report, private direct outbound investments are expressly allowed. NDRC will draft an Outbound Investment Regulation to strengthen the legal development for Chinese outbound investments. NDRC will also coordinate with other governments to simplify the approval process and to build a

comprehensive servicing system combining fiscal policies, financial services and information sharing platform for outbound investments.

This report evidences China's further resolution in promoting and facilitating outbound investments after the promulgation of Circular 37. As mentioned above, trade and investments in/through Luxembourg to Europe are expected to expand as a result.

4. WHAT ARE THE RECENT DEVELOPMENTS IN THE FUND INDUSTRY BETWEEN CHINA AND LUXEMBOURG? WHAT ARE THE IMPACTS OF THESE DEVELOPMENTS?

In May 2014, the Luxembourg Stock Exchange listed the first Dim Sum Bond in the Eurozone, which was issued by Bank of China. It is referred to as the "Schengen bond" which has strengthened the Luxembourg Stock Exchange's position for the listing of offshore RMB bonds.

On 19 June 2014, a MoU was signed between the Luxembourg Stock Exchange and Bank of China that involves the creation of a strategic partnership between these two institutions and on 30 June 2014 another MoU was signed between the Asset Management Association of China and the Association of the Luxembourg Fund Industry with the purpose of deepening the collaboration between the two associations.

On 17 November 2014, the Shanghai-Hong Kong Stock Connect Pilot Scheme (the "**Stock Connect**") was launched, allowing cross-market trading between stock exchanges in Hong Kong and Shanghai. Subsequently on 28 November, Luxembourg's financial regulator, *Commission de Surveillance du Secteur Financier* ("**CSSF**"), granted the first authorisation to a Luxembourg UCITS to trade through the Stock Connect. Besides, a fast-track procedure for filing such applications with the CSSF will apply to the Luxembourg UCITS whose investment policy already permits exposure to A-Shares, as announced by the Association of the Luxembourg Fund Industry on 2 December. These UCITS only need to adapt their prospectus and KIID (Key Investor Information Document) to cater for the CSSF authorised access through the Stock Connect. These are the first steps toward unleashing EU-regulated funds, in particular UCITS, into the Stock Connect, since two-thirds of Europe's funds industry (about 13,000 global mutual funds) is domiciled in Luxembourg and regulated by the CSSF.

These developments are expected to reinforce Luxembourg's leading position in the fund industry in the Eurozone, and to attract more investors, especially from China, to set up funds in Luxembourg.

5. IS THERE ANY LIMITATION ON THE FUNDS FLOW IN LUXEMBOURG?

No, both the inflow and outflow of funds are not limited, including the remittance of profits, interests and capital. For example, approval from the tax authorities for the distribution of dividends is not required.

6. IN TERMS OF CHINA'S OUTBOUND INVESTMENTS TO EUROPE, WHY IS THE HONG KONG-LUXEMBOURG STRUCTURE OFTEN USED?

The obvious benefit of this structure is the minimisation of the exposure to withholding tax on dividends when they are paid by the European subsidiaries to the Chinese parent companies. Three layers of legislation are involved in this structure:

The first layer is the European Union (**EU**) Parent-Subsidiary Directive. Under this directive, the withholding tax on dividends is exempt when the following conditions are met:

- The Luxembourg recipient is either a resident company fully subject to tax in Luxembourg, or a Luxembourg permanent establishment of a foreign entity that falls within the scope of the Parent-Subsidiary Directive;
- The Luxembourg recipient company holds or commits itself to hold at least 10% of the capital of the payer company (or the shares were acquired for at least EUR 1.2 million) for an uninterrupted period of at least 12 months;
- The distributing company is another Luxembourg company or a qualifying EU company under the Parent-Subsidiary Directive.

The second layer is the Luxembourg national tax law, implementing the EU directives. Under the participation exemption regime, dividend income will be exempt from Luxembourg income tax.

The third layer is the double tax treaty between Luxembourg and Hong Kong. Under this treaty, 0% withholding tax on dividends will be payable if the beneficial owner in Hong Kong is a company which holds directly at least 10% of the capital of the Luxembourg company.

Thus, the withholding tax liability is minimized if the dividends are repatriated to China through the Hong Kong – Luxembourg structure, subject to the tax arrangements between China and Hong Kong.

Similarly, the tax liabilities on interests and capital gains are usually exempt through this structure, subject to taxation only in Hong Kong/China.

7. WHAT ARE THE ADVANTAGES OF USING LUXEMBOURG STRUCTURES OVER CAYMAN ISLANDS?

In recent years, Luxembourg has increasingly become the preferred platform to structure Chinese outbound investments in the light of government clampdowns on offshore tax havens such as the Cayman Islands. For example, the well-known acquisition of the Portugal's largest power producer by China Three Gorges Corporation, one of China's largest outbound M&A deals to date, used a Luxembourg company structure. The joint takeover of Putzmeister Holding by SANY Heavy Industry Co. and CITIC PE Advisors (Hong Kong) was also structured through a Luxembourg holding company.

A major reason for using a Luxembourg company structure is the tax advantages, especially in case of investments in assets subject to withholding tax (e.g. dividends, interests, etc.). A Cayman Islands structure is not the right option in this case, since one would suffer withholding tax in the source country. On the contrary, when a Luxembourg entity is used, the withholding tax gets eliminated either under the Parent-Subsidiary Directive, the Interest-Royalty Directive or the relevant Luxembourg tax treaty.

Also, Luxembourg is a well-known financial centre within the European Union. It ranks as an "AAA" credit-rated country and benefits from white-list status and international tax transparency compliance in line with OECD guidelines.

8. ARE THERE ANY PREFERENCIAL TREATMENTS FOR HIGH NET WORTH INDIVIDUALS TO INVEST IN YOUR COUNTRY?

Yes, Luxembourg now also offers a **privileged framework for private wealth management** with abolition of the net wealth tax for individuals, levying a withholding tax of 10% on interest income, maintaining the exemption of inheritance tax in direct line and - under certain conditions - the exoneration of capital gains realised on stocks and capitalisation products and the exemption on gifts made by hand under certain conditions as well.

Luxembourg also offers financially independent persons the opportunity of becoming a resident. Sufficient funds, a sustainable monthly income, permanent housing, and full health insurance, in accordance with the local standards and laws, are the main prerequisites. Visas, where required, are obtained swiftly and most documents may be processed in English.

Apart from existing vehicles such as the **Luxembourg family holding company** or the **securitisation vehicle**, which are often used for managing high net worth, Luxembourg is about to adopt in the upcoming months a new state-of-the art framework especially designed for high net worth individuals – **the Luxembourg private foundation regime**. The private

foundation will offer a considerable degree of flexibility both in terms of management and governance. It actually may own movable and immovable properties, tangible and intangible assets or enter into insurance contracts as a subscriber or a beneficiary. It may also create other public or private foundations or trusts or be the beneficiary of such vehicles.

The tax treatment applicable to the private foundation appears to be particularly attractive.

Firstly, although the private foundation is subject to corporation income tax at the standard corporate income tax rate, it is possible to minimise such tax liability, as it will benefit from an exemption regarding its investment income: dividends, profit sharing and interest payments derived from securities, and capital gains realised on the sale of assets;

Secondly, income distributions made by the private foundation to non-resident beneficiaries are not subject to withholding taxes.

This article was first published in China Law and Practices in October 2014 and updated in January 2015.