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Information Letter

Hong Kong's Double Tax Treaties- Main attributes- Advantages in using HK and its DTAs

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Introduction:

Foreign Investors have always focused on the advantages that Hong Kong offers due to its territorial tax system, but with the Hong Kong Government entering into an increasing number of Comprehensive Double Tax Treaties (CDTA's) there is an increased opportunity for foreign investors who hitherto might have used other jurisdictions for tax treaty reasons to take full advantage of what Hong Kong CDTA's might offer. The combination of Hong Kong's territorial tax system and use of a HK CDTA offers a compelling package in certain situations not only for corporates but also individuals who can base themselves or a business in Hong Kong.

1. Main features of Hong Kong CDTA'S

1.1 It may be useful at the outset to summarise CDTA's that Hong Kong has currently entered into or are pending ratification as well as the double tax agreements that HK has had in force for some time in respect of shipping and aircraft business. We refer to the list in the schedule below;

1.2 Until June 2001, the Hong Kong had no comprehensive double taxation agreements in place. Since under the "territorial principle" only Hong Kong source income is taxable the double taxation of income does not usually occur thereby obviating the need for double taxation treaties in most cases. However, the HK Government was probably under some political pressure to implement CDTA's for reasons unrelated to international taxation.There had been some concern within Hong Kong that the territory may become 'black listed' by the OECD, or be on the receiving end of sanctions for failing to implement the internationally-agreed standard on tax transparency and information exchange confirmed at the April 2009 G20 Summit in London. Accordingly, legislation came into operation in March 2010 which allows Hong Kong to enter into comprehensive DTAs, incorporating the1995 Organisation for Economic Cooperation and Development (OECD) international standard on exchange of information;

1.3 Under article 151 of the Basic Law the territory can negotiate its own double taxation treaties independently of China using the abbreviation Hong Kong, China. The territory is not able to take advantage of any double taxation treaties which China may enter into because only mainland taxes are mentioned in these treaties. Nor will China impose the terms of any double taxation treaties on the territory given that under articles 106-108 of the Basic Law it guaranteed Hong Kong the right to maintain an independent taxation system free of interference from the mainland until the year 2047;

1.4 Prior to China assuming sovereignty over in 1997 Hong Kong Hong Kong did grant a unilateral credit for tax paid by a Hong Kong individual or company in a commonwealth country but on the changeover that credit was no longer available;

2. Specific examples of Hong Kong's CDTA's

2.1 We cannot deal with all HK- CDTAS's in this information letter. Those wishing to trade through HK in or with a HK treaty country, such as China, Thailand, Japan, New Zealand, etc should examine the treaty in question in detail. We will however comment on the Belgium and United Kingdom treaties which adopt most of the principles in the other HK- CDTA's;

2.2 The first is Belgium. We refer to Belgium because it was the first CDTA granting bi-lateral tax relief that HK entered into with a European country and also because for planning purposes Belgium does not levy NRWT on dividends and may serve as a suitable intermediary between a HK company and business generating profits outside HK;

2.3 Prior to the Agreement, royalties received by a Hong Kong resident from a Belgian source not attributable to a permanent establishment in Belgium were subject to a Belgian withholding tax at 15% on the gross amount of royalties less a 15% fixed deduction. Under the Agreement, the Belgian withholding tax has been reduced to 5% of the gross amount of royalties (without the 15% fixed deduction). In the case of interest received by a Hong Kong resident that arises in Belgium and which is not attributable to a permanent establishment in Belgium, the Belgian withholding tax has been reduced from 15% of the gross amount of interest to 10% under the Agreement;

2.4 Authority for the HK Government to implement double tax relief as in the Belgium CDTA was granted under section 50 of the Inland Revenue Ordinance in HK (“IRO”). Under HK source rules, while it is possible for profits earnt by a subsidiary owned by a HK company to be taxed under HK source rules, that is exceptional and in most cases relief under a HK CDTA’s will come in relation to dividends, royalties and interest. Limited relief is however available under a HK CDTA in respect of income that may be taxed twice. In essence, the CDTA’s in HK provide for a credit for foreign tax paid as follows:

(a) The amount of any credit allowable under section 50 of the IRO is limited to the Hong Kong tax payable on the relevant income;
(b) The rate of HK tax is calculated by dividing the total HK tax chargeable on the person for the year by the person’s total income for the year;
(c) For the purpose of the income calculation no deduction is allowed for any foreign tax, and as other tests rely on a remittance test and whether income includes a dividend, they are effectively irrelevant as HK imposes no tax on a remittance basis or on dividends;
(d) However, a deduction is allowed for any amount by which the foreign tax on the relevant income exceeds the credit available for such foreign tax;
(e) Other criteria are that total income is calculated without deduction for foreign tax and that total tax credits available for a year cannot exceed total HK tax payable for the year.

2.5 By comparison with Belgium, we would now like to summarise the main features of the HK- UK CDTA.

(a) In June 2001, Hong Kong entered into a limited agreement with the United Kingdom covering shipping transport. The agreement was limited to revenues from international shipping transport and provides that profits derived from such business by an enterprise of the UK or Hong Kong are exempt from tax in the territory of the other contracting party. Entering into force on May 3, 2001, the provisions of the agreement applied in the UK from April 1, 2002, for corporation tax, and from April 6, 2002, for income tax and capital gains tax. It applied in the SAR from April 1, 2002;

(b) An updated UK/Hong Kong Double Taxation Agreement was signed on June 21, 2010 and entered into force on December 20, 2010;

(c) The updated treaty reduced withholding tax on Hong Kong residents receiving dividends from UK Real Estate Investment Trusts from 20% to 15%. Also, withholding tax on Hong Kong residents receiving royalties from the UK is capped at 3%, instead of the non-treaty rate of 20%;

(d) On interest paid to a beneficial owner in the other jurisdiction the rate is nil (previously 20%);

(e) Pensions derived from HK by returning expatriates to the UK will bear HK tax and not UK tax. HK tax will be considerably lower than UK tax. This provision has been greeted with enthusiasm by UK returning expatriates and financial planners;

(f) UK will, with some minor exceptions, have the primary right to tax interest, dividends and capital gains even if arising in HK;

(g) Although the IRO contains no definition of who is a “ resident” of HK for the purposes of the CDTA (HK has a territorial tax system), the CDTA itself has a definition which is likely to be interpreted in the same way as the HK- China Comprehensive arrangements for the avoidance of double taxation, since the definition is the same. In my comments on using HK CDTA’s I will deal with residence in more detail. However, it should be noted at this stage that there may be situations where a corporate could have dual residence in both UK and HK and unless the tax authorities can agree who has the primary right to tax, no benefits under the HK- CDTA’s would be available;

(h) The Hong Kong/UK CDTA supersedes the existing limited double taxation avoidance agreements for airline income and for shipping income;

(i) The agreement also serves an Exchequer protection role by including provisions to combat tax avoidance and evasion – partly by measures providing for the exchange of information between revenue authorities. All of the UK’s recent double taxation agreements largely follow the approach adopted in the Organization for Economic Cooperation and Development’s (OECD) Model Tax Convention on Income and on Capital. The Arrangements scheduled to the Order continue that approach;

(j) The HK- UK CDTA WAS effective in the United Kingdom from April 1, 2011 for corporation tax, and from April 6, 2011 for income tax and capital gains tax. It was effective in Hong Kong from April 1, 2011;

(k) We will refer later to some other aspects of the HK- UK CDTA which may be relevant to those wishing to engage in structural planning take advantages of the CDTA.

3. Exchange of Information and Disclosure of Information Rules:

3.1 The 1995 version of the OECD Model Tax Convention for the Exchange of Information obliges HK to exchange information with other treaty countries when requested to do so. To ensure that taxpayers were provided with a fair set of procedures the Inland Revenue (Disclosure of Information) (Disclosure Rules) were adopted;

3.2 In brief, the Disclosure Rules provide for criteria that must be observed in making a decision over disclosure, and, most importantly, the IRD must, prior to any disclosure, notify the person concerned about the disclosure;

4. Transfer Pricing:

4.1 Transfer pricing can be a complex topic and we do not propose to go into too much detail, mainly because whereas many countries have quite detailed transfer pricing legislation, Hong Kong, in the absence of a CDTA, does not have any such legislation. Accordingly, no adjustments can be made to the profits of a Hong Kong entity

notwithstanding in a situation of economic double taxation (two resident entities assessed on the same profits) or juridical double taxation (same enterprise subjected to tax on the same profits in two jurisdictions) that profits may re- allocated and adjusted in a non -DTA country outside Hong Kong;

4.2 Where HK has a CDTA with another country there is provision for adjustment of the profits of a HK entity where both economic double taxation and juridical double taxation occurs and both refunds of tax paid or a credit for foreign tax paid are adjustment mechanisms.

5. Use of HK CDTA's by Foreign Companies and Individuals

5.1 Introduction;

(a) We have already alluded to the advantages of a business say in UK or other foreign jurisdictions using Hong Kong's territorial system to accumulate tax free profits in Hong Kong. In the vast majority of cases use of a HK CDTA by the foreign business to avoid double taxation will not be necessary save where the HK CDTA may be utilized to avoid or alleviate withholding taxes on dividends, royalties and interest;

(b) However, a foreign business that has an office in Hong Kong and either carries out business locally or is deemed to have earnt profits in Hong Kong by application of HK source rules, will need to have recourse to a HK- CDTA assuming the foreign jurisdiction has entered into a CDTA with HK. If it has not, the foreign business must face the real possibility that no bi - lateral alleviation of double tax in Hong Kong is possible and the party will have to be reliant on whatever unilateral relied might be available in the home country for tax paid in Hong Kong;

(c) Some jurisdictions, even in the absence of a CDTA with Hong Kong (Australia is an example) may still be able to plan to warehouse profits in Hong Kong free of local tax if conducting an active business with a real presence in Hong Kong and the profits are not remitted back to the home county;

(d) In the majority of cases, where a foreign party establishes a subsidiary to trade in Asia or to access China, the real advantage will be able to use HK CDTA's to alleviate foreign withholding taxes, royalties and interest;

(e) Despite the advantages of a HK CDTA in certain circumstances, it is not necessary when setting up what may be a treaty shopping structure to involve a country with which HK as a CDTA. In the area of withholding taxes on dividends, while Belgium may not impose NRWT on dividends remitted to a HK holding company, there are a number of other jurisdictions where dividends are paid out with little or no withholding tax and these jurisdictions were used and will continue to be used before and after the HK CDTAs came into effect;

(f) Notwithstanding HK's source rules, there may still be circumstances where interest sourced outside Hong Kong and royalties, even if subject to withholding tax, could be taxable in Hong Kong, so use of a country with a CDTA with Hong

Kong may well be an advantage. We recommend careful planning when implementing a structure, as in most cases, utilizing HK source rules and a CDTA, most taxes can be avoided or substantially reduced;

(g) We turn to the issue of residency as it applies to a HK CDTA. Although the tests may differ slightly in some of HK CDTA"s we intend to use residence definition in the HK- UK CDTA as a typical example. Whether a business or entity is resident in HK is obviously the first issue to consider in planning to take advantage of any HK -CDTA.

5.2 <u>Residency:</u>

(1) <u>Individuals:</u>

(a) For a person or corporate to become liable to tax in HK, a person must carry on a trade or business. Carrying on a business is not defined under the IRO but little activity is needed to trigger a business presence for tax purposes. If however an investment is made in HK by a resident of a jurisdiction with which HK has concluded a CDTA any domestic law is over-ridden and a liability to HK tax can only arise only if a permanent establishment (PE) as defined in the CDTA is established. Even if there is a PE, domestic source law could not be over- ridden by the CDTA; as an example, a PE might place funds on deposit in a bank outside HK but as the interest does not have a HK source, it could not be subject to tax in HK;

(b) Under the HK- UK CDTA a HK resident is defined to include individuals who ordinarily reside in Hong Kong or who stay in HK from more than 180 days during the year of assessment or more than 300 days in two consecutive years of assessment, one of which is the relevant year of assessment;

(c) By contrast, from a UK perspective, the terms, "residence", "ordinary residence" and "domicile" are not defined and each case is determined on its own merits. However, if in UK for more than 183 days in a tax year, an individual would be resident in UK under domestic law;

(d) As there is no PE test for an individual, it may be possible for a UK resident to be " treaty resident" in Hong Kong;

(e) Since the inception of the HK- UK CDTA it has been possible for a UK resident to meet the HK residence test(and avoid tax in UK) if:
(1) The individual is not present in UK for more than 183 days;
(2) The income is paid by a non- UK employer;
(3) Remuneration does not come from a PE in the UK;
(4) HK tax is paid on the income- this condition is not common in other DTA's.
Obviously, the difference in the 15% tax rate in HK with the UK rate will be very substantial. However, tax returns will have to be filed in both HK and UK to claim the exemption.

(f) The source of Directors fees will generally be the place where they are paid so fees will be taxed in UK if a UK company and vice versa.

(g) The source of fees for independent consultants is determined by reference to a PE which is defined as to include " a fixed place of business through which the business of an enterprise is wholly or partly carried on" or " furnishing of services by an enterprise (including consultancy services)". The word " business" is defined to include " the performance of professional services and other activities of a professional character. As an example, a business carried on by a HK resident in a fixed place in the UK will be a PE. On the other hand, a consultancy business carried on by a HK resident individual in the UK will be deemed to have a PE in the UK if the services are rendered in the UK for more than 183 days in any rolling 12 month period.

(h) In light of the above service PE definitions for individuals we would recommend all UK individuals who may have duel operations in the UK and HK consult professional advisers before adopting any particular structure where employee or consultancy income is earnt. Planning options for individuals are obviously available which were not available before the HK-UK CDTA;

2. Corporates:

(a) A company is deemed resident in Hong Kong if it is incorporated in Hong Kong or, if it is incorporated outside HK, is " normally managed or controlled in Hong Kong" This test is somewhat broader than the usual " management and control" test used in most common law jurisdictions and certainly less stringent than the test in the HK- Japan CDTA which refers to "central management and control" meaning actual director presence in HK is required;

(b) In DPIN 44 (IRD Departmental Practice Notes) the HK IRD defines " control" in the HK- China Double Tax Arrangements to mean control of the whole business at top level, making strategic decisions and policies, choosing business financing, whereas management means day to day to day management or implantation of top management decisions. Although control or management functions may take place in different places, if either control or management normally takes place in HK, the Company will be resident there for the purposes of the CDTA;

(c) We have already made reference to dual residency of a Company in both UK and HK, and in that situation, the test to be adopted in HK will be where the "place of effective management is located. The HK IRD in its interpretation notes just quoted maintain this is where the most senior persons formulate direction and work plans for the Company. Again, when considering a structure using HK, control and management issues should be addressed. Use of local nominee directors in HK is common, but unless they are real directors with decision making power, control is still likely to be in the foreign jurisdiction.

(d) It should be noted that a building site which lasts more than 6 months will be regarded as a PE for the purposes of the HK- UK CDTA;

5.3. **Disclosure:**

(a) We mention disclosure again in reference to the UK treaty. The exchange of information provisions enables the relevant authorities in Hong Kong and the UK to exchange information about taxpayers which they consider is foreseeably relevant for enforcement of their own domestic laws. This does not require information to be exchanged on an automatic or spontaneous basis but on request. Information exchanged about a taxpayer remains confidential, disclosable only to a court or to a body concerned with collecting, or enforcing tax.

5.4 **Anti- Avoidance:**

(a) Anti- avoidance or treaty shopping provisions are included in HK CDTA's and a typical example is in the UK treaty;

(b) While the withholding tax alleviation provisions already referred to are generous, it should be noted that they are not available if the main purpose (or one of the main purposes) is to create a situation to take advantage of the CDTA;

(c) Interest from a UK company to an unlisted HK company can only be paid free of UK withholding tax if the UK tax authorities give an advance ruling that the main purpose (or one of the main purposes) of establishing or maintaining the HK company was not the securing benefits under the treaty.

5.5 **Planning using the HK- UK CDTA and other HK- CDTA's**

(a) We have already referred to the benefits available to a HK company with a CDTA with another treaty county, and the opportunities that may be available to individuals and corporates from the UK who can establish PE residency in HK;

(b) We suggest that trustees currently holding assets in jurisdictions with which Hong Kong has a CDTA may wish to review their current structures. Holding those assets by means of a Hong Kong holding company owned by the trust may allow greatly reduced withholding taxes on dividends, interest or royalties, if applicable;

(b) Of most interest to UK corporates would be the interest and royalty articles under which the rate of withholding tax in the source state on interest and royalty payments can be reduced to zero and 3 per cent respectively;

(c) The withholding tax provisions mean that Asia based groups may use HK as a hub to hold, finance and license IP rights into the UK or the EU through a UK company;

(d) It also means that UK companies and other jurisdictions may invest in Asia via HK. EU companies may also do so perhaps via an intermediate UK company thus utilizing to the full the HK- UK CDTA.

(e) Although anti- avoidance measures must be borne in mind, the zero per cent withholding tax on interest paid by a UK corporate borrower to a Hong Kong lender that could treat the interest as being non-Hong Kong source income and, therefore, not taxable, means that certain private equity funds may use a Hong Kong company for debt financing. We do not have expertise in European structures but understand that offshore partnership vehicles would route debt finance needed to make UK acquisitions via a Luxembourg company in order to avoid the 20 per cent UK withholding tax on interest. Instead a Hong Kong company capitalised with equity could make loans directly to a UK borrower which may now be a simpler and more attractive alternative;

(f) However to use the loan structure mentioned the Hong Kong company must satisfy the limitation on benefit (LOB) provisions in the interest article;

(g) The LOB provisions are intended to restrict the benefit of the interest article to listed Hong Kong companies or those that can demonstrate to the UK authorities they have not been set up simply to obtain the benefit of the treaty. Given an existing private equity fund which uses a Hong Kong company as a vehicle for, say, its Asian investments, it may be possible to obtain a clearance and adopt a modified structure;

(h) The royalties article does not contain the same LOB provisions. It however does include a more standard anti- avoidance restriction which prevents the article being relied on where the main purpose with the creation or assignment of an IP licence in respect of which the royalties are paid is to obtain the benefit of the article. While professional advice should be taken, it seems likely this provision would catch any new Hong Kong intermediary licensing companies set up. However, an existing Hong Kong company that holds IP rights which it licenses to other companies in the same group may be able to benefit;

(i) One article in the treaty that should be mentioned as it is different from the standard OECD model. The article which allocates the right to tax capital gains on the disposal of land to the state in which the land is situated has been extended. It now allows such state to tax residents of the other state on disposals of companies whose value is more than 50

per cent attributable to land in that first state. Neither HK or the UK currently taxes non-residents on disposals of land situated in their jurisdiction. It seem unusual to include a clause extending the taxing rights to disposals of shares in companies whose value is primarily attributable to land but this provision is included in some other HK CDTA's.

6. Summary:

(a) Quite clearly, the HK- CDTA's will add to HK's attractiveness not only as a trading centre in Asia, but will offer increased opportunities for companies from UK, Europe and other jurisdictions to use HK as a hub for financing and licensing to take advantage of alleviation of withholding taxes.
(b) Remember too that HK will continue to enter into CDTA's and we have no doubt that for those prepared to examine in detail each HK- CDTA advantageous planning structures will present themselves.

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LIST OF CDTA AND SHIPPING/AIRCRAFT TREATIES

Double taxation avoidance treaties are in force between Hong Kong and the following countries (with 'in force' dates):

- Austria (January 1, 2011)
- Belgium (July 7, 2004)
- Brunei (December 19, 2010)
- Hungary (February 23, 2011)
- Ireland (February 10, 2011)
- Japan (August 14, 2011)
- Liechtenstein (July 8, 2011)
- Luxembourg (January 20, 2009)
- China (April 10, 1998, second protocol signed 2006)
- Thailand (December 7, 2005)
- Vietnam (August 12, 2009)
- UK (December 20, 2010)

Double taxation agreements between Hong Kong and the following countries have been signed but are awaiting ratification (with signature dates):

- France (October 21, 2010)
- Czech Republic (June 6, 2011)
- Indonesia (March 23, 2010)
- Kuwait (May 13, 2010)
- Mainland China (Third Protocol, August 21, 2010)
- Netherlands (March 22, 2010)
- New Zealand (December 1, 2010)
- Portugal (March 22, 2011)
- Spain (April 1, 2011)
- Switzerland (December 6, 2010)

Hong Kong also has signed double taxation agreements concerning aviation and shipping income with a number of countries (although some of these agreements have been superceded by recently-signed comprehensive double tax avoidance agreements). Countries with which Hong Kong has signed these limited double tax agreements include:

- Bangladesh - aviation
- Belgium - aviation
- Canada - aviation
- Croatia - aviation
- Denmark - aviation/shipping
- Ethiopia - aviation
- Finland - aviation
- Germany - aviation/shipping
- Iceland - aviation
- Israel - aviation
- Jordan - aviation
- Kenya - aviation
- Korea - aviation
- Kuwait - aviation
- China - aviation
- Mauritius - aviation
- Mexico - aviation
- Netherlands - aviation/shipping
- New Zealand - aviation
- Norway - aviation/shipping
- Russia - aviation
- Singapore - aviation and shipping
- Sri Lanka - aviation and shipping
- Sweden - aviation
- Switzerland - aviation
- UK - aviation/shipping
- US - shipping

There is also a memorandum of understanding with China.