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Issues Concerning Double Taxation and Tax Relief in Hong Kong after July 1997

■ *Alfred Kwok-ki Chan*
Partner
K.K. Chan and Company
and
Alan B. Davis
Assistant Professor
Department of Accountancy
City University of Hong Kong

Background

After 156 years of British colonial rule, the crown colony of Hong Kong became the Hong Kong Special Administrative Region (HKSAR) of the People's Republic of China (PRC) on 1 July 1997 under the terms of the Sino-British Joint Declaration.[1] In 1990, the National People's Congress enacted the Basic Law, which serves as a mini-constitution for the HKSAR after the change in sovereignty. Under the terms of the Basic Law, the HKSAR shall be vested with executive, legislative and independent judicial powers, and will have full autonomy to manage all of its affairs except for matters concerning foreign and defense issues.[2] In addition, the HKSAR has legal authority to maintain and develop relations and relevant international agreements with foreign parties in economic affairs,[3] and to continue the international agreements concluded before the handover.[4]

The transfer of sovereignty brought about a change in the source of taxing power and taxing jurisdiction, which now are derived from the Basic Law in contrast to the Letters Patent under British rule.[5] Under the principle of "one country, two systems", Hong Kong will have an independent tax system[6] and will be fiscally separated from the central government.[7] Thus, the basic framework of the Hong Kong tax system has continued as it was before the change in sovereignty.

Double taxation exists when the same taxpayer is subject to taxation by more than one jurisdiction on the same income. The objective of this paper is to examine the conditions under which double taxation will arise within a Hong Kong context and suggest potential solutions to the problem both for HKSAR policy-makers and practitioners. The remainder of this paper is divided into six sections. The first section provides examples of how double

taxation might arise within a Hong Kong context. The second section discusses unilateral solutions to the problem. The third section discusses bilateral solutions to the problem in the form of double taxation agreements between countries. The fourth section contains a brief description of the tax treaty network of the PRC and a discussion of the applicability of these treaties to the HKSAR. The fifth section provides a discussion of the issue of the definition of "Chinese national" as it relates to the issue of PRC tax treaties and HKSAR taxpayers. The final section is a conclusion.

Double Taxation in Hong Kong

Double taxation on income will continue to exist after the handover due to overlapping tax jurisdictions between HKSAR and her trading partners including the PRC. In general, double taxation would arise under the following circumstances:

1. a person is a resident and/or citizen of two taxing jurisdictions that impose tax on worldwide income (for example, an American citizen who is a resident of Australia would be liable to tax in both jurisdictions);
2. the same income is considered to be derived from two different jurisdictions under different source rules (see example 1 below);
3. income is taxed in the country of source but is also taxed in the country of residence.[8]

Example 1 - Royalties

Instances of double taxation arise under different tax rules adopted by different tax jurisdictions. For example, a Hong Kong company may be concurrently paying taxes in two jurisdictions for the same royalty income it receives from foreign companies under different tax rules at home and abroad. The royalties may be subject to taxation in Hong Kong because the royalty licensing contracts are negotiated and concluded in Hong Kong. At the same time, the tax authority in the country of the payer company[9] may also tax the same income for reason that the royalty income may be either sourced where the payer resides or where the licenses are used, or the rights to use the license are exercised.[10] Some Hong Kong manufacturers or computer software companies may also face double taxation on income received from overseas licensees.[11]

Example 2 - Interest

Double taxation occurs indirectly under different tax rules on income and expenses because interest income is taxed in one jurisdiction, while expenses are not deductible in another jurisdiction from the perspective of the group. For example, a Hong Kong taxpayer can claim interest expenses for the earning of assessable income under very limited circumstances. If the interest bearing loan is not obtained from a financial institution but from a company outside Hong Kong, say a parent company in PRC, then interest expenses are not deductible in computing Hong Kong assessable profits. However, the interest income receivable by the PRC corporation will technically be taxable because PRC imposes tax on resident companies in respect of worldwide income.[13] Because the interest is taxable to the recipient and not deductible to the payer, it is subject to double taxation.

Example 3 - Sales

In respect of the sales which are generated by overseas branches or offices, the Hong Kong headquarter company may also be liable for taxes both in Hong Kong and the countries where the sales offices or branches are located. Under Hong Kong tax law, the Hong Kong company is subject to tax on grounds that purchases contracts are effected or the performance of the contracts is carried out in Hong Kong.[14] The tax authorities in the foreign countries will also impose tax on overseas sales offices and

branches concerning the same income by reason that some profit generating activities such as concluding sales contracts or regular replenishment of stock in trade are performed there. The court cases of *Sinolink Overseas Limited*[15] and *Magna Industries Company Limited*[16] illustrate that income derived from trading activities might be double taxed under different tax rules due to the fact that these companies had created taxable presence in more than one jurisdiction.

Example 4 - Dividends

Although Hong Kong tax law specifically exempts dividends from taxation, there are still problem areas for Hong Kong investors as they pay a higher non-treaty rate of withholding tax on a gross basis for the dividend income distributed by foreign companies resident in the investee countries. Strictly speaking, this is not a double taxation issue but one of taxing authority distribution between different tax jurisdictions. Thus, Hong Kong investors suffer from a higher withholding tax rate in the source country because Hong Kong does not have comprehensive tax treaties with her trading partners to limit the withholding tax rate on dividends. Similarly, foreign source interest and royalty income receivable by Hong Kong corporate and noncorporate persons will be subject to withholding tax at source at the higher non-treaty rate.

Unilateral Relief

Unilateral relief is granted by one of the taxing jurisdictions to mitigate the problem of double taxation. Two forms of unilateral relief will be discussed, the exemption method and the tax credit method.

Exemption Method

Unlike most tax systems, Hong Kong does not employ a residency tax jurisdiction but rather uses a territorial source jurisdiction. Thus, offshore income is exempt. The intersection of the two types of tax jurisdictions produces some interesting results. For example, before the PRC opened its doors in 1979, the profits derived from Hong Kong manufacturing operations were wholly taxable because the manufacturing activities were performed locally. After the migration of the manufacturing sector to mainland China, the profits so earned became exempted and not taxable in Hong Kong.[17] Note that such exemption is given unconditionally. There is no requirement that any taxes on the offshore manufacturing profits need be paid elsewhere. Since the Hong Kong manufacturer is entitled to take advantage of various tax incentives and tax holidays offered by the PRC government, they are not be subject to tax in the PRC. After the tax holiday period is over, the Hong Kong manufacturer has to pay tax at full rates,[18] depending on whether or not they can shift the income to a low tax jurisdiction.[19] Thus, their tax cost will rise drastically in the absence of any tax planning. The tax cost in this case can only be relieved by way of deduction from Hong Kong source income, which is limited in scope itself. In fact, there is no provision in the Inland Revenue Ordinance to relieve double taxation by granting tax credits to Hong Kong companies for tax suffered outside Hong Kong.[20]

Hong Kong exporters of goods and services are also subject to a higher degree of taxation in foreign countries where sales and distribution activities are organized or services are provided by Hong Kong-based employees traveling back and forth overseas. That discourages Hong Kong exporters to go further international and expand their distribution network overseas. But for the absence of tax treaties, Hong Kong exporters could have been protected under the "permanent establishment" article. It assigns part of the taxing rights to their home jurisdiction and limits the taxing jurisdiction of

the host country given that a certain threshold of taxable presence in the host country, say no more than six months, is not exceeded. For example, the business profits article of the PRC-Singapore tax treaty provides that "the profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein".[21] In addition to the normal six-month exemption, there are planning opportunities to reduce taxation in the host countries because the definition of permanent establishment in tax treaties is often more lenient and narrower in scope than that provided in domestic income tax law,[22] and the provisions of tax treaties normally override domestic income tax laws.[23] However, in the absence of tax treaties, the extended meaning of permanent establishment as provided in domestic tax laws shall apply to Hong Kong companies. It is expected that more Magna-type cases[24] will come up in the future. Hong Kong outbound investors are still exposed to double taxation if Hong Kong tax laws remain unchanged. Therefore, the new HKSAR government should consider either establishing some form of unilateral tax relief or enter into a network of double taxation agreements with her trading partners.

Tax Credit Method

In contrast, if Hong Kong inbound investors pay taxes on locally sourced profits at the corporate level, the Hong Kong taxes may be credited against the tax payable in the investor's country where the taxing jurisdiction is exercised on worldwide income by reason of his residence. At the shareholder level, the dividend income is excluded from tax at source in Hong Kong.[25] In the country of residence of the investors, the dividend income will be tax-exempted, taxed on receipt basis or taxed on an "as earned" basis, depending on the tax laws of the respective countries of the inbound investors. For example, in Singapore, corporate or non-corporate residents are exempted from income derived from Hong Kong if the income is not received in Singapore.[26] If income is received in Singapore, it will be taxable in Singapore with any Hong Kong taxes deductible from taxes payable in Singapore. Under section 50A of the Singapore Income Tax Act, a unilateral tax credit is available for dividend income received by Singapore residents. The credit extends to the underlying foreign tax on the profits out of which the dividends are paid if the resident owns at least 25% of the capital of the dividend paying company.[27] In Canada, dividend distributed from companies carrying on active business in Hong Kong will be taxed on a receipt basis. The dividend income will be exempted from tax if more than 10% equity is held by Canadian residents and the company carries on business in treaty countries such as the PRC. Passive income including dividend from investment will be taxed on an as-earned basis if the income is derived from companies located in a non-tax treaty jurisdiction such as Hong Kong.[28] In the U.K., the controlled foreign companies (CFC) legislation, which requires CFC's to pay tax at 33% on 90% of the taxable profits computed under the U.K. tax rules, applies to a British resident-controlled investment holding company incorporated and not engaged in active business in Hong Kong,[29] but not to any Singaporean companies because Singapore has a tax treaty with the U.K.

Bilateral Relief

Bilateral relief is granted by the application of a tax treaty between the two taxing jurisdictions. Unilateral relief alone may not provide sufficient incentive to inbound capital and investment in Hong Kong. Fiscal policies in the home countries as well as non-tax factors will affect the decision of foreign investors as to whether they will invest and

do business in Hong Kong. In particular, use of Hong Kong companies as a device for tax deferrals are discouraged by foreign countries and the use of Hong Kong companies as holding companies will often not be tax efficient for inbound investors. If the income is not taxed in Hong Kong, it will, in the absence of tax sparing provisions, find its way to the state treasury of Hong Kong's trading partners through the operation of their domestic tax laws, therefore resulting in reduced Hong Kong revenue and no benefit to the Hong Kong economy. In contrast, Singapore has a tax treaty with Canada under which taxes spared or forgiven by Singapore for Canadian investment in Singapore are deemed paid for Canada foreign tax credit purposes.[30]

On the outbound front, unilateral tax relief cannot avoid double taxation or obtain the benefits of tax treaties including protection of permanent establishment, lower withholding tax rates, and nationality non-discrimination, which will be discussed later in this article. Ironically, Hong Kong outbound investors may, in some cases, achieve a higher after-tax return if they structure their investment in the PRC by way of a company in Singapore, which has a tax treaty with the PRC.[31]

In contrast to Singapore and other major economic powers in Asia, Hong Kong does not have a comprehensive tax treaty with any foreign jurisdiction. There is a limited agreement with the U.S. relating to shipping profits. Also, Hong Kong recently has entered into double tax agreements with South Korea, New Zealand, and Canada on airline profits. The new HKSAR government should be encouraged to aggressively seek an extensive tax treaty network similar to that of Singapore.

Applicability of PRC Tax Treaties to HKSAR

The PRC has an extensive tax treaty network with over 50 countries. There are double tax relief provisions in the PRC tax treaties.[32] With Hong Kong's transfer of sovereignty, one question arising is whether a resident of the HKSAR can use PRC tax treaties to shield herself from double taxation. In other words, do the PRC tax treaties apply to the HKSAR after the handover? Constitutionally, it is viable to adopt the PRC tax treaties to HKSAR in that Article 153 of the Basic Law provides that

"The application to the Hong Kong Special Administrative Region of international agreements to which the People's Republic of China is or becomes a party shall be decided by the Central People's Government, in accordance with the circumstances and needs of the Region, and after seeking the views of the government of the Region..."

Admittedly, tax treaties are international agreements. It appears that there is a legal backing for the application of the PRC tax treaties to HKSAR unless the Central People's Government or HKSAR decides otherwise. However, an examination of the PRC tax treaties would give us different views on the issue. The PRC tax treaties implicitly exclude the applicability of the tax treaties to HKSAR. The major provisions in support of this argument include the personal scope, taxes covered and exchange of information provisions.

1. Personal scope

   A typical personal scope provision is as follows: "this agreement shall apply to persons who are residents of one or both of the contracting states".[33] To claim the treaty benefit, two conditions must be satisfied: first, an en-

tity must be a legal person under the relevant law; second, the entity must be a resident of one of the countries. The definition of resident is found in the tax treaty entered into between PRC and other countries. For example, provision 1 of Article 4 of the double tax treaty between PRC and U.S. states that, "for the purpose of this agreement, the term 'resident' means any person who, under the laws of that Contracting States, is liable to tax therein by reason of his domicile, residence, place of head office, place of incorporation or any other criterion of a similar nature". Similarly, the same wording is found in other PRC tax treaties. Under the PRC Income Tax Laws for Foreign Investment Enterprises and Foreign Enterprises (PRC Unified Income Tax Law),[34] the term "resident" and "non-resident" are not explicitly provided. Nor is the term, "person" defined therein. However, Article 41 of the General Provisions of the Civil Code of the PRC provides that FIEs possessing the characteristics of legal persons, which in compliance with the regulations, are duly registered with the State Administration for Industry and Commerce, shall be PRC legal persons. Article 39 of the Civil Code also provides that the domicile of a legal person must be at the location of their head office. The Unified Income Tax Law (Article 3) provides that an entity having its head office in the PRC shall be subject to taxation on their worldwide income (from both inside and outside PRC). Article 5 of the Detailed Implementation Rules of the Unified Income Tax Law further provides that "head office" means the central establishment that is located inside the PRC and is responsible for the operation, the management and control of the foreign investment enterprise incorporated as a legal person under the laws in China. Therefore, the linking of the Civil Code with the Unified Income Tax Law ensures that all PRC enterprises fulfill the treaty requirements of residency under the personal scope provisions of the tax treaty.

In the case of Hong Kong taxation, the scope of charge to tax is limited to locally sourced profits; that is, profits derived from business carried on in Hong Kong regardless of the place of incorporation and residence. Even if a person is physically present and working in Hong Kong for 365 days in the year, he is not regarded as a resident for tax purposes under the personal scope provision of the PRC tax treaty.[36] Clearly the PRC Income Tax Law satisfies the resident requirement in the personal scope article while Hong Kong tax law does not. Furthermore, the Hong Kong Inland Revenue Department is not obliged to issue Certificates of Residence to taxpayers under the Hong Kong Inland Revenue Ordinance as proof of residence if required by overseas tax authorities.

2. Taxes covered

It is provided in the PRC tax treaty that the "taxes covered" refer to the Individual Income Tax, the Income Tax concerning Joint Ventures with Chinese and Foreign Investment; the Income Tax concerning the Foreign Enterprises, and the local income tax. It also provides that the PRC treaty shall also apply to any identical or substantially similar taxes that are imposed after the date of signature of the agreement in addition to, or in place of, the existing taxes referred to above.[37] The PRC Income Tax Law imposes tax on residents in respect of worldwide income and taxes non-residents on PRC-sourced income while Hong Kong tax law only taxes locally sourced profits, irrespective of the taxpayer's residence and place of incorporation. In addition, the PRC Income Tax rate is considerably higher than the Hong Kong tax

rate.[38] One other point to note is that "taxes covered" includes local income taxes. It appears that Hong Kong's tax is a PRC local income tax because Hong Kong is part of the PRC after the handover. However, a closer examination of the PRC Income Tax Laws reveals that the base and the rate of Hong Kong tax is not identical and similar to the PRC local income tax.[39] Obviously, the tax rate and the scope of charge to Hong Kong tax are not identical and substantially similar to that for the PRC tax. Thus, it is unlikely that the PRC tax treaties are applicable to Hong Kong persons.

3. Exchange of information

The provision for guaranteeing the confidentiality of taxpayer's information as contained in section 4 of the Inland Revenue Ordinance will clash with the obligations to exchange information with the other contracting states under the PRC tax treaties. In the absence of tax treaties, it is difficult for tax authorities of Hong Kong's trading partners to enforce their domestic tax rules in Hong Kong to combat cross-border tax evasion.

The absence of exchange of information between the tax authorities will give rise to cross-border tax evasion. For example, the Hong Kong branch of a PRC subsidiary of a U.S. corporation is taxed on profits earned in Hong Kong in year 1. If the Hong Kong branch does not agree with the assessment of the Inland Revenue Department, it can appeal directly to the Hong Kong judicial system. In year 2, the court hands down a decision that the profits of the Hong Kong branch are derived from a non-Hong Kong source and therefore not taxable in Hong Kong. Unless the PRC subsidiary voluntarily reports the tax refunded to the Hong Kong branch in year 2,[40] the end result will be that the taxpayer will obtain relief in the U.S. for Hong Kong taxes that were actually refunded to the taxpayer. Thus the income is not taxable in either jurisdiction because the same branch income was not taxed in PRC in year 1 under the tax relief article of the PRC Income Tax Law[41] which applies to the U.S. subsidiary in the PRC. The absence of exchange of information will lead to a non-taxation situation in all three jurisdictions. As the information of the Hong Kong taxpayers is kept confidential by the Inland Revenue Ordinance except under very few circumstances,[42] the Hong Kong Inland Revenue is not obliged to disclose any information to the tax authorities in other jurisdictions, theoretically including the PRC tax authorities. As a result, the tax authorities of Hong Kong's trading partners including the U.S., U.K., Japan, and Singapore have announced that Hong Kong is one of the listed tax havens, to which the tax treaties are not applied.[43]

Therefore, it is the conclusion of this article, that PRC tax treaties will not be applicable to the HKSAR in general. However, Hong Kong residents may be able to seek relief under PRC treaties as discussed in the next section.

Non-discrimination Article[44] and Definition of Chinese National

In line with the policy goal to compete for foreign direct investment with other capital importing countries, the PRC tax treaties prohibit discrimination against non-nationals. The non-discrimination article, subject to reciprocity, protects non-nationals from being subjected to any taxation treatment which is other or more burdensome than that imposed on nationals of the other states in the same circumstances.[45] A person who is a national of a contracting state may benefit from the provision even though he is a resident of neither state. In case

of proven discrimination, the aggrieved taxpayer shall have the right conferred by the non-discrimination provision to raise a complaint to the tax authorities in the country, of which he or she is a national. The OECD non-discrimination article adopted in PRC tax treaties provides:

> "Nationals of a Contracting State should not be subjected in the other Contracting State to taxation or requirements connected herewith which is other or more burdensome than that the taxation or connected requirements to which nationals of the other states, in the same circumstances in particular with respect to residence, are or may be subjected."

It appears that the non-discrimination provision is relevant to the Hong Kong Chinese nationals after the handover in that the application of the article is not restricted by the personal scope article to nationals solely who are residents of a contracting state. On the contrary, it extends to all national of each Contracting State, whether or not they are residents of one of them.[46] Even though Hong Kong people are not considered as PRC residents for tax purposes, it is possible that the Hong Kong people doing business or investing in the PRC tax treaty countries can seek tax relief by relying on the operation of the non-discrimination provision. The reason being PRC nationality laws are applied to the HKSAR.[47] Hong Kong Chinese people automatically acquired the status of Chinese nationals after 30th June 1997 unless they chose to declare otherwise. The second paragraph of the Chinese Memorandum to the Joint Declaration provides:

> "Under the Nationality Law of the People's Republic of China, all Hong Kong Chinese compatriots, whether they are holders of the "British Dependent Territories Citizens' Passport" or not, are Chinese nationals."

Similarly, the term "national" in tax treaties covers not only individuals, but also legal persons, partnerships, and associations deriving their status from the laws in force in a contracting state. If the company is incorporated in Hong Kong, it is uncertain whether it will be considered to have acquired the status of Chinese national. If this is the case, then the PRC tax treaties may be applicable and a lower treaty rate of withholding tax may apply to the Hong Kong company. Thus, there is a partial relief of double taxation on the licensing income and the dividend income that is referred to in the earlier part of this article. In theory, it is tempting to say that the Hong Kong company can rely on the protection accorded by the non-discrimination article in the PRC tax treaties.

Finally, the dates of entry in force of the tax treaties are relevant concerning the application of the tax treaties. It might be argued that if the tax treaties are signed after the date of the Joint Declaration, the HKSAR might have been factored in concluding the tax treaties. Therefore, the treaty parties intended to apply the treaties to Hong Kong as well. There may be problems in applying the tax treaties to Hong Kong if they were signed and entered into force before the date of Joint Declaration. For example, while most PRC tax treaties are silent on this issue, the recently negotiated tax treaty between the PRC and Sweden specifically excludes the HKSAR from its provisions. This is consistent with the practice of British treaties, which routinely contained a clause excluding the terms of the treaty to any overseas territories.

Conclusion

The following are quoted as the proven tax-related factors of success for Hong Kong: low tax rates, high tax thresholds for individuals, high depreciation allowances, no capital gains tax, no tax on

offshore income, no tax on dividends, no VAT, no consumption tax, no turnover tax, no payroll tax, no thin capitalization rules, no withholding tax in general, and losses can be carried forward for setoff indefinitely.[48] It is a good policy for Hong Kong to maintain low tax rates and a simple tax system in that it has, to some extent, achieved the purpose of attracting inbound capital and investment. However, there is no case for complacency. The new Administration of the HKSAR should note that the fiscal policy of Hong Kong has been ineffective in three important areas: First, a territorial taxation system that imposes low tax rates and exempts foreign source income will not be conducive to the conduct of outbound trade and investment. Instead, the existing fiscal system has put Hong Kong outbound investors in a very disadvantageous position if they are to trade and invest in high tax jurisdictions that impose tax on worldwide income. Second, Hong Kong companies may not be a good investment vehicle or conduit either for foreign and Hong Kong investors to do business in or channel investment to the PRC, because Hong Kong lacks a comprehensive tax treaty to eliminate or reduce double taxation. Third, lowering tax rates and granting of tax exemption on income will only further cut into the narrow tax base and revenue.

It is a fallacy that double taxation will only arise in rare cases, because firstly, Hong Kong exempts offshore income and has a very narrow tax base for onshore income. Secondly the major trading partners unilaterally grant tax credit to their residents on income that are subject to tax in Hong Kong. However, that point of view has been off target and has failed to consider the case of overlapping taxing jurisdictions, benefits of tax treaties and the impact of the fiscal policies adopted by Hong Kong's major trading partners and competitors on the flow of inbound investment to Hong Kong. With the continuing advance of China's modernization drive, Hong Kong's economic link with the mainland will become even closer and its role as a bridge will be increasingly enhanced.[49] It is highly desirable that some bilateral relief is in place for Hong Kong to avoid double taxation. Bilateral relief also provides certainty to the flow of capital and investment and ways of sharing tax revenue between the source and residence countries, and possibly increasing Hong Kong revenue in some cases. In the case of HKSAR, it is highly unlikely that PRC tax treaties will apply to the HKSAR, because the bases and the rate of taxation for Hong Kong and the PRC are different and dissimilar. Nonetheless, the issues concerning the applicability of the non-discrimination provision to Hong Kong Chinese nationals are not yet resolved on the theoretical side, and the possible outcomes not yet tested in practice. This issue requires further study. T

Endnotes

1. The Joint Declaration of the Government of The United Kingdom of Great Britain and Northern Ireland and The Government of The People's Republic of China on the Question of Hong Kong, signed and concluded on 19th December 1984.
2. Chapter 2 of the Basic Law, adopted at the Third Session of the Seventh National People's Congress of the PRC on 4th April 1990 and put into effect as of 1st July 1997.
3. Article 151 of the Basic Law.
4. Article 153 of the Basic Law.
5. Ernst & Young, Taxation in Hong Kong 1995/96, p.1.
6. Article 108 of the Basic Law.
7. Article 108 of the Basic Law.
8. Note that an individual taxpayer could be a resident of Australia, a citizen of the U.S., operating a business in Hong Kong and thus be subject to triple taxation.
9. *CIR v. HK-TVB International Ltd* (1992) 1 HKRC 90-064, HK Revenue Legislation, CCH International.
10. For example, see US Internal Revenue Code, sections 861(a)(4) and 862(a)(4).