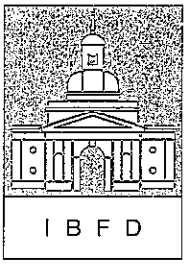

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An International Perspective on Tax Developments in the Asia-Pacific Region

CHINA

Taxation of Hong Kong Residents and Foreign Nationals

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I. INTRODUCTION

Since the People's Republic of China ("PRC") adopted the open-door policy in 1979, foreign investors have brought huge amounts of capital and relocated numerous employees to the country. As a net capital-importing country, the PRC has made corresponding changes in her legal system including the enactment of the PRC Individual Income Tax Law on September 1980. Subsequently, the old PRC Individual Income Tax Law was amended and the new PRC Individual Income Tax Law was promulgated on 31 October 1993, and came into effect as from 1 January 1994. Since then, there have been many changes and development of the PRC Individual Income Tax Law (the "PRC IIT Law").[1]

To exercise the taxing jurisdictions and to protect the revenue base, the PRC has followed the international practices of adopting both residence and source principles in making the PRC Income Tax Law. Nonetheless, the PRC has formulated her own set of income tax rules under the PRC IIT Law according to the characteristics, and the stages of development of her political, social and economic systems. It is recognized that staff cost is one of the major considerations in deciding to relocate employees to work in the PRC whose tax system has a relatively high effective tax rate in the Asian region.[2]

One objective of this article is to provide information for investors to understand the residence and source principles: the boundary of the PRC individual income tax jurisdiction inside which the PRC tax liabilities arise. This article will also examine what connecting factors are used to define residence, the dividing lines between residence and non-residence, the tax rules under which employment income is taxed, and the boundary to these tax rules under the PRC IIT Law.

Under the principles of "One Country, Two Systems", the Basic Law provides that the Hong Kong Special Administrative Region (the "HKSAR") shall continue to have an independent and low-tax system and shall be fiscally separate from the Central People's Government.[3]

Because of a very close economic relationship and geographic approximation between the PRC and the HKSAR, it is useful to know how residence is defined and the taxing rights are allocated under the arrangement between the two sides in respect of the taxation of employment income. This article concludes with a discussion on some issues that need to be addressed by the fiscal policy makers concerned.

First, it is admitted that there is a difference between the PRC and the Mainland of China as the former includes the HKSAR. In what follows, however, the PRC is used to refer to the jurisdiction of the Central People's Government where the PRC IIT Law is in force.

Second, the concept of income under the PRC IIT Law is wider in scope than that provided in the Hong Kong tax law relating to employment income. Only income from *employment* is included in discussion in this article.[4] Accordingly, it is assumed that employment income is the only source of income for the Hong Kong employee working in the PRC.

Third, this article examines the issues relating to the PRC IIT Law from the perspective of a Hong Kong employer as the investor that provides capital and sends employees to work in the PRC. However, a Hong Kong employer may hire employees from jurisdictions other than Hong Kong for whatever reasons.

The PRC tax implications and the Arrangement are relevant experiences to those Hong Kong employees who, due to administrative concession or the provision of domestic

1. Under the legal system of the PRC, the National People's Congress delegates its rule-making power to the State Council. In turn, the State Council delegates its power to the Ministry of Finance, and the State Administration of Taxation ("SAT"), with authority in that order. Since 1994, the State Council, the Ministry of Finance, and the State Administration of Taxation have issued many rules concerning the interpretation and implementation of the PRC IIT Law. These rules, including the tax treaties concluded with other jurisdictions and "The Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income" (which is effective as from 1 April 1998 in the HKSAR and from 1 July 1998 in the PRC), are collectively regarded as part of the PRC IIT law in the PRC tax system.
2. The highest marginal tax rate under the PRC IIT Law is 45%, with a very small deduction amounting to CNY 48,000 in a year regardless of the marital and family status of the individual employee. Accordingly, some employers have to implement tax equalization schemes to shelter their employees from the high PRC taxation, and absorb the employees' tax costs.
3. Arts. 106 and 108 of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China.
4. The PRC IIT Law divides income into ten categories, plus a catch-all provision.

tax laws, are exempt from tax on foreign employment income in their home jurisdictions.

II. TAXATION OF RESIDENT INDIVIDUALS

A. General

The PRC IIT Law provides that:

> Individuals who are domiciled in the PRC or who are not domiciled but have resided in the PRC for more than one year shall pay individual income tax in accordance with this Law on income derived from sources in and outside the PRC.

Domicile here means a permanent home.

The Implementation Rule of the PRC IIT Law specifically provides the following two criteria for an individual to be PRC-domiciled and therefore subject to tax on worldwide income. It states that a domiciled individual is one who has a household registration in the PRC, or who habitually resides in the PRC, because of family connection or economic interests and relations.[5]

If the individual is not domiciled but residing in the PRC for 365 days in a calendar (tax) year,[6] the non-domiciled individual is also a tax resident. In ascertaining the total number of days a non-domiciled individual resides in the PRC, no account is taken of the period of temporary absence in the tax year. The threshold for temporary absence is:[7]

- 30 days for a continuous absence in the tax year; and
- a total of 90 days in the tax year if the absence is not continuous.

Once it can be established that domicile and periods of physical presence are the connecting factors between the person and the country, the person is a PRC tax resident. A PRC resident is subject to tax on worldwide income regardless of the source of his income, and is entitled to the benefits of foreign tax credit for tax paid in respect of non-PRC source income.

B. Exemption

Foreign nationals including Hong Kong employees who reside in the PRC over one year but less than five years are not taxed by reason that they are "domiciled in the PRC", but by reason that they derive income from employment performed during the period of their physical presence in the PRC. The PRC IIT Law imposes tax on worldwide income regardless of whether the salary is paid by a resident employer or a non-resident employer. However, during the period of temporary absence as defined above, income paid by a resident employer is taxable and income paid by non-PRC resident employers is tax-exempt, subject to the approval from the supervising tax authorities.[8] Commencing from the sixth year of residence, foreign employees are subject to tax on worldwide income, and the above exemption is not applicable.

A PRC tax resident can become a non-tax resident under certain conditions. If the employee, in the sixth year of his residence or thereafter, stays outside the PRC for a continuous period of over 30 days, or for periods aggregating more than 90 days, the five-year rule of tax on worldwide income will not apply. In this case, the individual employee is entitled to start afresh. The five-year rule will apply again after a *second* five-year residence.[9]

C. A brief comparison with the old PRC IIT Law

The old PRC IIT Law used the period of physical presence as a sole criterion to establish PRC residence. The concept of domicile was not adopted. However, the concept of tax by reason of nationality was adopted in the PRC Individual Income Adjusting Tax Law (the "PRC IIAT Law"), which was applied to PRC citizens other than foreign individuals. When the PRC IIAT and the old PRC IIT Law were merged and consolidated into the existing PRC IIT Law, nationality was not used as a connecting factor to impose tax.

Second, the old PRC IIT Law imposed tax on the employees who resided in the PRC for over one year but less than five years in respect of PRC-source income. Non-PRC-source income was taxable only on a receipt basis when it is remitted into the PRC. The PRC IIT Law imposes tax on a "place of exercise of employment" basis irrespective of where the income is received.

III. TAXATION OF NON-RESIDENT INDIVIDUALS

A. General

The PRC IIT Law provides that the following categories of individuals are non-residents, and thus only liable to tax on PRC-source income:

- individuals who are not domiciled and not resident in the PRC;
- non-domiciled individuals who reside in the PRC for less than 365 days in a calendar year; and
- non-domiciled individuals who, having been physically present in the PRC during the preceding calendar year and thus having acquired a residence status, stay outside the PRC either for a continuous period of 30 days, or for periods exceeding in the aggregate 90 days, in the current calendar year.

The PRC IIT Law taxes non-residents on income arising from employment exercised in the PRC irrespective of the taxpayer's residence.[10]

Employees holding senior positions and general employees are subject to different tax rules.

5. If the employee gets married to a PRC resident, the employee is considered to be domiciled in the PRC because of the existence of family connections. Similarly, an employee may become domiciled in the PRC if he obtains a PRC household registration consequent upon the purchase of a house situated in the PRC.
6. Art. 44 of the Implementation Rule of the PRC IIT Law.
7. Art. 3 of the Implementation Rule of the PRC IIT Law.
8. Art. 6 of the Implementation Rule of the PRC IIT Law.
9. Circular No. [1995] 098 issued by the Ministry of Finance and the SAT on 16 September 1995.
10. Art. 1 of the PRC IIT Law.

Holders of senior managerial positions such as the director, the legal representative, or the chief representative are subject to the PRC individual income tax throughout the period of their office or contract of services until they step down from the positions or the service contract terminates. The income has a PRC source and is taxable even if the employee receives the payment outside the PRC.[11] The tax exemption for stays not exceeding 183 days in a calendar year does not apply to this category of employees.

In contrast, employees holding non-managerial positions are taxed by reason of the activities they engage in in the PRC, subject to the 90-day exemption rule.[12] This exemption extends to 183 days for employees who are residents of a PRC tax treaty country, and residents of the HKSAR.[13]

B. The 90-day / 183-day exemption rule

If a non-domiciled employee performs services in the PRC for less than 90 days / 183 days in a calendar year, the income is exempt from taxation subject to the following conditions being satisfied:
- the income is paid by, or on behalf of, an employer who is not a resident in the PRC; and
- the income is not borne by a permanent establishment or a fixed base set up in the PRC by a non-resident employer.

The PRC IIT Law adopts the "duration of activity" method and the "days of physical presence" method. The counting of 183 days includes rest days, public holidays and training days when the employee is working for a PRC resident, or working with a permanent establishment or fixed base set up in the PRC by a non-resident employer.[14] A PRC resident employer includes, but is not limited to, a foreign investment enterprise.[15]

A permanent establishment or a fixed base is not defined in the PRC IIT Law, but it is provided in the Implementation Rule of the PRC Income Tax Law for Foreign Investment Enterprises and Foreign Enterprises. The term "permanent establishment" includes, among others, management establishments, offices, workshops, factories, construction sites, all set up inside the PRC by the non-resident employer. However, if the employee stays in the PRC over 183 days in the year, the exemption will not apply. In that case, the employee's worldwide employment income is fully taxable in proportion to the number of days spent in the PRC.[16] This is so regardless of:
- the number of his employment contracts;
- who pays the employee; and
- where the payment is made or received.

Note that there is a distinction between "income not liable to tax" and "income exempt from tax". "Income liable to tax" and "income not liable to tax" are mutually exclusive. For example, the distribution received by an inheritor from the estates of a decedent does not have the quality of income, and therefore it is not liable to income tax. The employee is liable to tax but he need not pay it because the income is exempt or specifically excluded under the provision of the PRC IIT Law. In the absence of the exemption, the tax rules provide that the employee is liable to tax even if he works in the PRC for one single day in the year. This is so no matter who pays him, and where the payment is made. An illustrative example is the imposition of tax on income earned by a non-PRC resident singer or actor, who usually completes the performance activities in a very short period during his stay inside the PRC.

C. Connecting factors and the income source rules

To determine whether the non-resident employee has a taxable presence as a consequence of what he did in the PRC, one has to examine the various source rules in the PRC IIT Law that link up the PRC with the activities that generate the income.

First, one has to examine whether, under the terms of the service contract, the employee holds a senior position with a PRC resident company, a permanent establishment or fixed base set up in the PRC by the non-resident employer. If so, the income is taxable, without regard to:
- the residence status of the employer;
- the place of payment; and
- the duration of activity in the PRC.

Second, if the employer is a PRC resident, one has to find out whether the salary is paid by the employer. If so, the income is taxable.

Third, if the employer is a non-resident, one has to find out whether the employer has a permanent establishment in the PRC, or fixed base, as defined. If there is a permanent establishment or fixed base set up in the PRC by the non-resident employer, one has to find out whether the employee's salary is charged to the permanent establishment or the fixed base. If so, it is taxable. If the non-resident employer does not have a permanent establishment or fixed base in the PRC, one has to check whether the employee's presence in the PRC exceeds the 90-day or 183-day threshold in the calendar year. If so, it is taxable. As a related matter, the non-resident employer will have a taxable presence in the PRC because it will be deemed to have a permanent establishment in the PRC as a result of the activities performed by its employees.

Fourth, the PRC income tax status of the employer will also impact on the obligation of the employees under the PRC IIT Law. If the employer is exempted from PRC income tax or is taxed on a deemed income basis, the employee is deemed to have his employment income paid by the resident employer or borne by the permanent establishment or fixed base. The income is therefore taxable under that deeming provision. The tax liabilities arise regardless of whether the salaries are recorded in the books of accounts of:[17]

11. Art. 5 of the Implementation Rule of the PRC IIT Law.
12. Art. 7 of the Implementation Rule of the PRC IIT Law.
13. The Arrangement also provides for a 183-day exemption.
14. Circular No. 125 [1995] issued by the State Council on 23 March 1995.
15. Art. 2 of the PRC Foreign Investment Enterprises and Foreign Enterprises Tax Law provides that the term "foreign investment enterprises", as used in this Law, refers to Sino-foreign equity joint ventures, Sino-foreign cooperative joint ventures and wholly foreign-owned enterprises established inside the PRC.
16. Circular No. 148 [1994] issued by the SAT on 30 June 1994.
17. Id.

- the resident employer;
- the permanent establishment; or
- the fixed base set up by the non-resident employer.

A manufacturing plant operating under a processing contract concluded between a Hong Kong company and a PRC resident is one example of a tax-exempt permanent establishment set up inside the PRC. It has been the practice of the PRC tax authorities to grant concession to these economic activities organized inside the PRC. Consequently, the Hong Kong manufacturer is not required to pay income tax in the PRC.[18]

However, a representative office engaged in sales activities in the PRC, but failing to provide sufficient information to the PRC tax authorities, may be taxed on a deemed income basis.

A foreign investment enterprise subject to corporate income tax on a deemed income basis is another example. It is a common practice for the shareholders of the foreign investment enterprise to engage auditors in the shareholder's home country to perform audits in the PRC. The audited financial statements, without legal force in the PRC, are nonetheless used to comply with the financial reporting requirements in the home country of the non-resident shareholders. In the absence of information exchange, the PRC tax authorities would have difficulties in knowing whether or not the salaries of the resident employees are, in part or in whole, borne by the foreign investment enterprise.

It is worth noting that the deeming provision is a specific anti-avoidance provision. Under any one of the above situations, the employee has a liability for individual income tax on income earned during his presence in the PRC because of the deeming provision stated above. The Hong Kong employer is obliged to withhold tax at source and pay it over to the State Treasury. Hence, both the employer and employee concerned should not rely solely on the 90-day / 183-day rule.

IV. DOUBLE TAXATION AND RELIEF

A. General

Income may be taxed under the tax laws of a country because of a nexus between the country and the person earning the income.[19] A jurisdictional claim over income based on such nexus is called "residence jurisdiction". Persons subject to the residence jurisdiction generally are taxable on their worldwide income, with no reference to the source of the income.

Income may also be taxed under the tax laws of a country because of a nexus between the country and the activities that generated the income with no reference to the residence of the taxpayer.[20] A jurisdictional claim based on such a nexus is called "source jurisdiction". Every jurisdiction has a boundary beyond which no tax can be imposed by it.

Double taxation arises from the clash and overlapping of different tax jurisdictions. Conflicts usually take the following forms: source-source conflict, residence-residence conflict, and residence-source conflict.

To solve the second and third type of conflicts, countries enter into tax treaties under which:
- the source country has the prior right to tax; and
- the residence country will either grant a tax credit or exempt the income from tax altogether.

Also, countries may enter into tax treaties to provide for tie-breaker rules:
- to avoid double taxation arising from dual residence; and
- to allocate the right to tax between the two countries.

B. Solution to residence-residence conflict

The Arrangement provides that salary income derived by crew members on board a ship, aircraft, or inland transport vehicle operating in international traffic is only taxable where the employer is a resident. Under the Arrangement, the right to tax is sorted out by agreeing on which side the taxpayer's employer is resident without reference to the employee's residence and where the employment is exercised.

C. Solution to source-source conflict

The PRC IIT Law imposes tax on the Hong Kong employee because the employment is exercised in the PRC. In the HKSAR, Section 8(1) of the Hong Kong Inland Revenue Ordinance (the "IRO") provides that salary tax is imposed on individuals in respect of income derived in Hong Kong from an office or employment. Here, Hong Kong salaries tax is imposed on the same income because of a legal obligation created between the employee and a Hong Kong employer regardless of the residence status of the employee and the place where the employment is performed. It is an example of the same income being doubly taxed under different domestic tax laws of the two sides. Source-source conflict resulting from claims by two taxing jurisdictions to impose tax on the same income according to their respective source rules presents difficulties to both taxing authorities and the taxpayer.

Double taxation cannot be avoided if the taxing authorities cannot settle the issue. In the absence of tax credit, the only way is that one of the taxing jurisdictions gives up its right to tax by granting exemption to the income that suffers foreign tax outside the home jurisdiction. Prior to the Arrangement becoming effective in 1998, the Hong Kong employee who had paid tax on income derived from employment performed in the PRC may rely on Section 8(1A)(c) of the IRO to claim exemption from Hong Kong.

18. The reply letter from the Guangdong National Tax Bureau and the Guangdong Local Tax Bureau to the Taxation Institute of Hong Kong on 28 October 1998.
19. Brian J. Arnold & Michael J. Mclutyre, *International Tax Primer*, Kluwer Law International, at 19.
20. Id.

salary tax.[21] Note that the exemption is granted unilaterally to both resident and non-resident Hong Kong employees alike.

D. Solution to resident-source conflict

The Arrangement provides that Hong Kong resident employees may rely on the double taxation relief provision in the Arrangement under which the resident employees are allowed tax credit against HKSAR tax for PRC tax paid, subject to imposed limits. Non-resident employees are of course not entitled to the benefits of PRC tax credit.[22]

V. ISSUES TO BE ADDRESSED

This article aims to illustrate the principles and concepts concerning taxation on employment income in the PRC IIT Law, and the interaction between the PRC IIT Law and the Arrangement. Still there are some issues that have not been dealt with in the PRC IIT Law and under the Arrangement.

First, even if the Circular No. 125 issued by the SAT provides for the public holidays to be included in computing the 183 days spent inside the PRC, it is inconclusive as to how to interpret the 183 days. For example, the PRC IIT Law does not mention whether part of a day, day of arrival and day of departure, Saturday and Sunday, are included. The same is also true for:

- days of sickness;
- days spent inside the country of activity (i.e. the PRC), due to interruption because of strikes, flooding, earthquakes, delays in traffics; and
- days spent outside the country of activity due to death or sickness in the family.

The fact that the HKSAR is adjacent to the PRC makes it possible for anyone to travel to and fro within hours. There is concern for those Hong Kong employees who are not stationed in the PRC but who need to travel frequently to discharge duties in the PRC, and then return to Hong Kong at the end of the day. Indeed, there is a ruling of the Hong Kong Inland Revenue Board of Review over a salary tax case that part of a day was counted as a whole day.[23] Both parties to the Arrangement should agree upon clear rules that govern the ways in which 183 days are interpreted, and the methods used. Otherwise, there is still chance of double taxation.

Second, several conditions must be satisfied for the remuneration of the non-resident employee to qualify for the exemption. One of the conditions is that the exemption is limited to the 183-day period, and that the 183-day period may not be exceeded "*in the calendar year concerned*" (emphasis added). It is noted that here, the Arrangement has adopted the wording in the 1977 version of the OECD Model Tax Convention. It would create a non-taxation situation where the fiscal years of the two sides did not coincide and opened up opportunities in the sense that operations were possibly organized in such a way that, for example, the employees stay in the other side for the last 5½ months of one year and the first 5½ months of the following year. The situation of double exemption would not have arisen if the Arrangement had adopted the following wording: the 183-day period may not be exceeded "in any twelve month period commencing or ending in the fiscal year concerned".[24]

Third, there is chance of other possible non-taxation since the Arrangement came into force. The provision in Article 3(2) of the Arrangement reads as follows:

> Notwithstanding the provisions of sub-paragraph (1) of this paragraph, remuneration derived by a resident of One Side in respect of an employment exercised on the Other Side shall be taxable only on the first-mentioned Side if:
> (i) the recipient stays on that Other Side for a period or periods not exceeding in the aggregate 183 days in the calendar year concerned; and
> (ii) the remuneration is paid by, or on behalf of, *an employer who is not a resident of that Other Side*; and
> (iii) ... (emphasis added).

The term "employer" is not defined in the Arrangement. It can be a resident of a third jurisdiction, for example, a company incorporated in the British Virgin Islands. Unless specifically provided, the employer does not have to be a resident of the jurisdiction where the employee is resident. If a Hong Kong resident employee hired by a BVI company performs his duties in the PRC for less than 183 days during the year, the tax consequences on both sides will be as follows. In the PRC, the employee will not be subject to PRC individual income tax because his income is exempt from individual income tax under the provision of the Arrangement. In Hong Kong, he will not have any salary tax liabilities because he has not signed any employment contract with a Hong Kong company, nor has he rendered any services in Hong Kong. A well-drafted agreement should serve the purpose of avoiding double taxation and eliminating non-taxation that might result in a loss of revenue. Such a taxing gap would have been closed if the drafters of the Arrangement had referred to the Commentary of the Model Tax Treaty Convention as recommended by the OECD.[25]

The fourth issue is that the Arrangement has adopted the definition of residence, but there is no definition of residence in the IRO.[26] Since 1947, Hong Kong has been a source jurisdiction under which the IRO only imposes taxes on locally sourced profits and income derived from Hong Kong employment.[27] Section 49 of the IRO, how-

21. Sec. 8(1A)(c) of the IRO was enacted in 1987. Art. 7 of the PRC IIT Law provides a unilateral credit to relieve PRC resident from tax suffered for employment performed outside the PRC.
22. Art. 4 of the Arrangement provides that:

> [W]here a resident of the HKSAR derives income from the Mainland of China, the amount of tax paid in the Mainland of China in respect of that income in accordance with the provisions of this Arrangement shall be allowed as a credit against the HKSAR tax imposed on that resident.

23. D12/94, 23 May 1994 Inland Revenue Board of Review, Hong Kong, Hong Kong Revenue Legislation CCH Asia Limited.
24. Commentary on Art. 15, OECD (1997) Model Convention.
25. The Commentary on Art. 15 provides that contracting parties are "free to adopt bilaterally the alternative wording of sub-paragraph (ii) : the remuneration is paid by, or on behalf of, an employer who is a resident of the first-mentioned State, and...".
26. The Inland Revenue Department, in the capacity of administrator of the IRO, has dealt with the issue in the Departmental and Interpretation Practice Note No. 32. However, the Practice Note has no legal force.
27. Secs. 14 and 8 of the IRO.

ever, provides that the Arrangement "shall have effect in relation to tax under this Ordinance notwithstanding anything in any enactment". That has created a legal vacuum between the Arrangement and the IRO.[28]

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Model Tax Convention on Income and on Capital (1997), OECD Committee on Fiscal Affairs, OECD, Paris.

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28. After concluding the Arrangement with the PRC on 11 February 1998, the residence principle has been incorporated into the Hong Kong tax law by way of the Specification of Arrangement Order made by the Chief Executive in Council under Section 49 of the IRO. The HKSAR government has introduced a radical change in the Hong Kong tax system. The Hong Kong tax net has expanded from a source jurisdiction to what looks like a combined residence and source jurisdiction. In that respect, the implications will be beyond the space of this article.