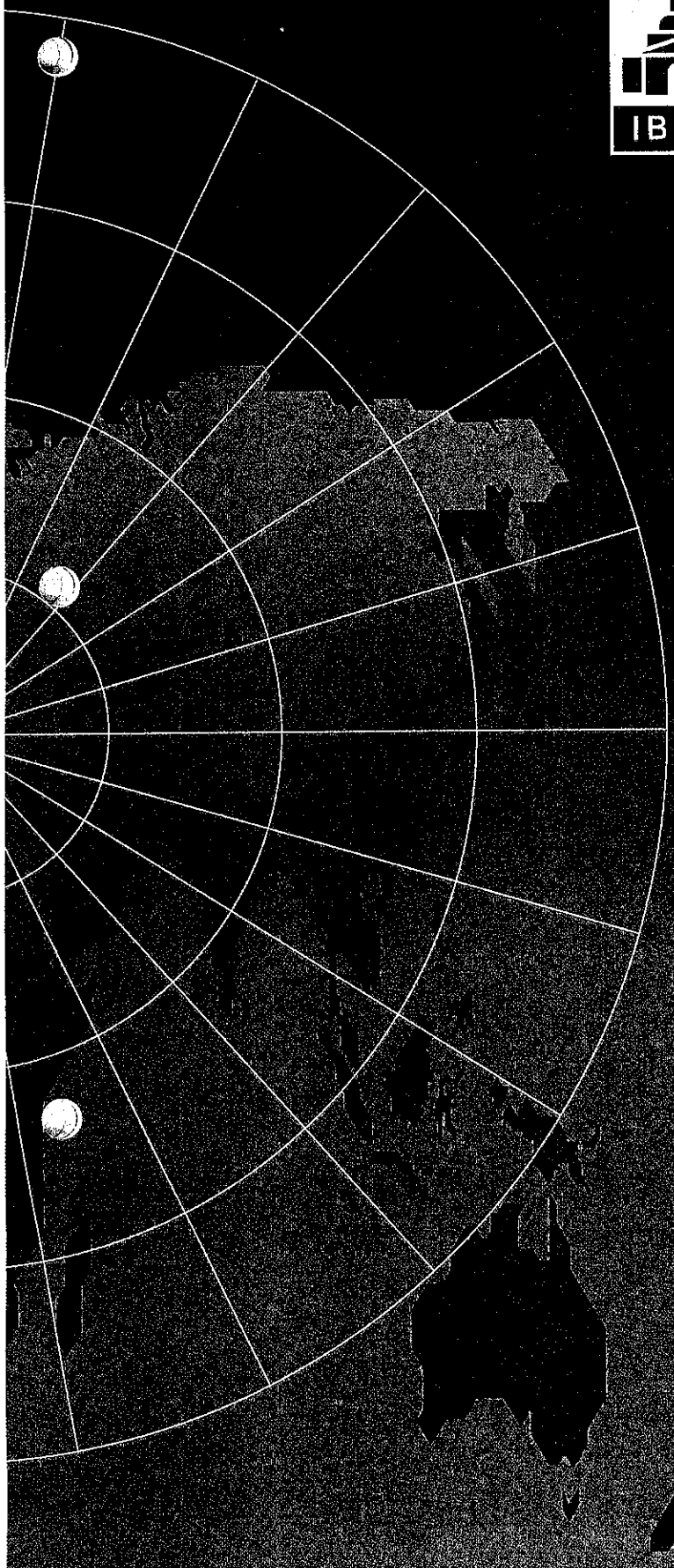

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Contribution of articles

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Hong Kong

A Commentary on Hong Kong's Tax Treaties

Contents

1. Introduction

It is generally accepted that the countries enter into tax treaties in order to avoid double taxation, assign taxing rights and prevent fiscal evasion.[1] The government of Hong Kong Special Administrative Region (henceforth known as Hong Kong) has signed agreements for the avoidance of double taxation on income (the tax treaty) with 28 countries and regions.[2] The scope of most of Hong Kong's tax treaties is limited to the avoidance of double taxation on shipping and air service income, without including the taxation on business profits. Out of the 28 tax treaties, three were recently concluded with Belgium, Thailand and the People's Republic of China (China),[3] and these three tax treaties have basically followed the OECD Model Convention (OECD MC) version. It is observed that the interaction of the Hong Kong domestic tax rules and the comprehensive tax treaties has resulted in situations of double non-taxation.

This article will first introduce the basic concepts and principles in taxation in general, including an examination of the reasons for double taxation, the various forms of double taxation and the ways of alleviating double taxation. Second, this article examines how countries use the principles of the OECD MC to allocate the taxing rights under the tax treaty. References to the tax treaty are used to illustrate how the conflicts of domestic tax laws are to be solved. Third, this article specifically examines the fiscal gap arising from loopholes in the tax treaty between Hong Kong and China regarding the taxation of business profits and employment income. Finally, by comparing differences in the tax rules, we try to explain why this has happened and propose a solution for consideration by the policymakers.

2. Overlapping of Taxing Rights

Double taxation can be classified into two types, i.e. juridical double taxation and economic double taxation. Juridical double taxation occurs where the same income is subject to taxation under the tax laws of two or more jurisdictions. Economic double taxation occurs where the same income is subject to more than one type of taxation under the tax laws within one jurisdiction.[4] In this article, reference is made to juridical double taxation.

To achieve equity between those who carry on business at home and those who carry on business abroad, taxes are imposed on worldwide income. Taxing worldwide income also ensures that gaps in fiscal evasion are limited because it is more difficult for a taxpayer to escape the tax net by shifting income away from the home country. A tax system that practises residence jurisdiction serves to safeguard a country's tax base. In a residence jurisdiction, tax is imposed because of the nexus between the country and the person earning the income, irrespective of where the person earns it. Depending on how residence is defined under the tax laws of a country, the overlapping of tax jurisdiction between countries may give rise to double taxation and cause hardship to the taxpayers. A simple illustration can help explain the reason for this.

Under the laws of Country A, income tax is imposed by reason that Country A is the place of incorporation of the taxpayer, while under the laws of Country B income tax is imposed by reason that Country B is where the management of the taxpayer abides (see Table 1).

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1. The OECD Model Convention (MC) also provides other auxiliary objectives of a tax treaty including resolving disputes, elimination of discriminatory taxation, and the exchange of information.
2. See information on the website of the Inland Revenue Department of Hong Kong at www.ird.gov.hk.
3. China and Hong Kong, on 21 August 2006, signed an "An Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion" which is effective on 1 January 2007 in China and effective on 1 April 2007 in Hong Kong. After the change of sovereignty in July 1997 Hong Kong shall maintain an independent tax system and shall be fiscally separated from the Central People's Government under the principles of "one country, two systems". See Art. 108 of the Basic Law of the Hong Kong Special Administrative Region, adopted at the third Session of the Seventh National People's Congress of China on 4 April 1990 and put into effect as of 1 July 1997. The Hong Kong–Belgium tax treaty and the Hong Kong–Thailand tax treaty were signed on 2004 and 2005 respectively.
4. Economic double taxation occurs where the income is taxed at the company level and the after-tax income is taxed again at the shareholder level in the form of dividend.

Table 1		
	Country A	Country B
Country of incorporation	Yes	No
Place of management	No	Yes

If the taxpayer who is incorporated in Country A locates its place of management in Country B, the taxpayer is liable to income tax in both countries, resulting in double taxation. Double taxation occurs because a country imposes tax on a person's worldwide income. It is the exercise of an extra-territorial sovereignty over the person who is the tax resident of the home country. A few examples of country tax laws can help illustrate this point. In China, domiciled individuals or non-domiciled individuals who live in China for 365 days in a calendar year are tax residents and thus liable to tax on income derived within and outside China.[5] The Chinese Enterprise Income Tax Law also defines a resident enterprise to be one that is incorporated in China, or if it is incorporated under the laws of other countries, the one whose actual management is located inside China.[6] To avoid cross-border double taxation on income, Country A can grant a tax credit to a taxpayer who is incorporated in Country A for tax paid outside the country. This can be done in two ways, i.e. (i) to unilaterally include the tax credit provision in its domestic tax law, or (ii) to hold talks with the government of country B and sign an agreement to avoid double taxation. The first method is known as a unilateral credit and the second, a bilateral credit. A tax system that imposes tax on worldwide income and grants foreign tax credits to the resident is generally a residence jurisdiction.

If the taxpayer who is incorporated in Country B sets up its place of management in Country A, the taxpayer is not liable to income tax in both countries, resulting in double non-taxation. Under the laws of Country A, the taxpayer who is incorporated in country B is not resident in Country A. Likewise the same taxpayer is not a resident under the laws of Country B since its place of management is located in another country, i.e. the taxpayer is a non-resident in both countries. To protect the tax base, countries pass laws to tax non-residents on their country-source income. The Chinese Individual Income Tax Law provides one example, i.e. "Individuals who have no domiciles and do not reside in the PRC or who have no domiciles but have resided in China for less than one year shall pay individual income tax on their income gained within China in accordance with the provision of this law".[7] A tax system that imposes tax on country-specific income is generally a source jurisdiction. In a source jurisdiction, tax is imposed because of a nexus between the country and the activities that generate the income, irrespective of the residence of the taxpayer. The domestic laws of the country give the definition of residents and non-residents, and also define the activities giving rise to country-source income. Whether the income is derived from the country depends on what a person does and where he carries out such activity. If the activity from which the income is generated takes place in the country, the income is subject to tax, otherwise it is not. A country can exercise both a residence and source jurisdiction.[8] The Hong Kong tax system is a source jurisdiction where non-Hong Kong source income is not subject to tax.[9]

3. Conflicts between Tax Laws

Domestic tax laws at the country level may conflict with those in other countries and thus give rise to double taxation. Conflicts can be classified into different types. The first occurs where the residence rules of one country are in conflict with the residence rules of another country (the residence conflict). The second occurs where the residence rules of one country are in conflict with the source rules of another (the residence and source conflict), while the third occurs where the source rules of one country are in conflict with the source rules of another country (the source conflict). To solve the conflict between country tax rules, countries enter into tax treaties to eliminate double taxation and allocate their respective taxing rights.

3.1. Residence conflict

The case of dual or even multiple residences occurs when a person is considered resident in a number of countries at the same time. To find a solution to this, the residence according to the criterion considered most appropriate should prevail. This is the solution followed in the OECD MC[10] and in the case of individuals, the following are a list of the elements to be considered, in that order:

- permanent home;
- centre of vital interests;
- habitual abode;
- nationality; and
- solution according to mutual agreement procedure.

The dual residence problem also exists for legal persons. The criterion of place of management normally takes precedence. It is interesting to note that Hong Kong corporate laws do not impose any residence requirement for the equity owner(s) or director(s) of a Hong Kong company.[11]

3.2. Conflict between residence and source rules

In addition to dual residence, a common case of overlapping tax rules takes the form of a residence and source conflict. See the following examples:

Example 1

A company incorporated outside China may carry out economic activities in China. The home country may impose tax on the company by reason that the company is a resident under the tax laws of the home country. The host country (i.e. China) may

5. See Art. 1 of the Chinese Individual Income Tax Law, as promulgated by the National People's Congress on 31 October 1993, and amended on 27 December 2005. The Implementation Regulation of the Individual Income Tax Law also provides that in counting the number of days for which an individual stays in China, no account is taken for temporary absence from China in the tax year. The threshold for temporary absence is 30 days for a continuous absence in the tax year, or a total of 90 days in the tax year if the absence is not continuous. See Art. 3 of the Implementation Regulation.
6. See Art. 2 of the Chinese Enterprise Income Tax Law, passed at the fifth session of the 10th National People's Congress on 16 March 2007. The Corporation Income Tax Law shall take the place of the Chinese Tax Law for Foreign Investment Enterprises and Foreign Enterprises on 1 January 2008.
7. See Art. 1 of the Chinese Individual Income Tax Law, promulgated by the National People's Congress on 10 September 1980, amended on 31 October 1993, 30 August 1999, and 27 December 2005 respectively.
8. Countries adopting both residence and source jurisdiction in tax law include China, Singapore, Canada, etc.
9. Another example is Macau. Both Hong Kong and Macau are special administrative regions of China.
10. Model tax treaties developed by OECD for references and use by the Member and non-Member countries in negotiating and concluding tax treaties.
11. The secretary of the Hong Kong company must reside ordinarily in Hong Kong if it is an individual, or have its registered office or place of business in Hong Kong if it is a body corporate. See Sec. 154(2) of the Companies Ordinance, Chap. 32 of the Laws of Hong Kong.

impose income tax on profits that are generated from the business activities if the presence of business activities constitutes a permanent establishment (PE), which may be categorized into the types shown in Table 2.

Table 2

Types	Activities	Forms it takes
1	Fixed place of business	Branch[1]
2	Presence of employees	Employees working on projects[2]
3	Concluding contracts	Sales agent acting on its behalf[3]

1. The term also includes especially a place of management, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry or any other place of extraction of natural resource.
2. In the tax treaty signed between China and Singapore, that type of activities also includes a building site, a construction, assembly or installation project or supervisory activities in connection therewith.
3. The term "agent" refers to a person who has authority to conclude contracts in the name of the enterprise within China or the other state under the tax treaty (the Agency PE), or a person who regularly secures orders in China or the other state wholly or almost wholly for the enterprise itself, or other enterprises, which are controlled by that enterprise. (Note that the provision for Order-securing PE only appears in the tax treaty signed by China with Japan).

Generally the issue of PE arises if the company of a home country carries on business in the host country by setting up a fixed place of business in the host country (i.e. Type 1), assigning its employees to work in the host country on projects (i.e. Type 2), or appointing a sales agent to act on its behalf in the host country (i.e. Type 3). Where a certain type of business activities constitutes a PE, the allocation of taxing rights will be to the host country, which shall impose tax, while the home country waives its right to tax. The source jurisdiction of the host country takes precedence over the home country that adopts the residence jurisdiction. The residence and source conflict is resolved by the above arrangement in the tax treaty as agreed by both countries.

Art. 7 of the China–United Kingdom (UK) tax treaty provides that, "the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to the permanent establishment." The "Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion" follows the same wording.

Table 3 lists the exceptions to the source override with respect to the types of activities as previously mentioned.

In respect of the allocation of taxing rights, tax treaties follow the principle that the taxing right rests with the host country where the activities from which such income arises are performed, while the home country surrenders its right to tax. In this respect, the taxing right of the home country is restricted. These taxing rights are also restricted in the host country under certain circumstances. For example, the activities solely performed in relation to the purchase of goods or merchandise inside China (the host country) for its non-resident headquarters are not taxable under the tax treaty provision.[12] That is a specific restriction to a general restriction in the tax treaty.[13]

Table 3

		The term PE is deemed not to include the following:[1]
Type 1	(i)	the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
	(ii)	the maintenance of stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
	(iii)	the maintenance of stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; and
	(iv)	the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of advertising, or of collecting information for the enterprise.
Type 2	(i)	the activities performed by the employee on the other side do not constitute a PE if the duration of activities is not exceeding 6 months in any 12-month period.
Type 3	(i)	the conclusion of a contract does not give rise to a PE on the other side if the contract is concluded in connection with the tax-exempt activities which are classified under Type 1 above.

1. See Art. 5(4) under the "Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion" (the Arrangement).

Example 2

Double taxation occurs where a Hong Kong airliner or shipping company operates between Hong Kong and China or between Hong Kong and other countries. Due to the nature of shipping and airliner business in international traffic, the vessel or aircraft must call at the ports or land on cities over which the government of each side can impose taxes. A special provision in the Hong Kong tax rules provides for this. Sec. 23D(1) of the Hong Kong Inland Revenue Ordinance (IRO) states that "... where a person ... carries on a business as an owner of aircraft, and any aircraft owned by that person lands at any aerodrome or airport within Hong Kong, that person shall be deemed to be carrying on that business in Hong Kong".

The conflict between tax claims over the same income is resolved by the tax treaty between the two jurisdictions which decides that the taxing right shall rest with the jurisdiction where the shipping or aircraft operator is resident. An examination of the tax treaty entered between Hong Kong and China (similarly with other comprehensive/limited tax treaties entered into by Hong Kong) can provide the answer, i.e. the "Revenue and profits from the operation of ships, aircraft or land transport vehicles carried on by an enterprise of One Side on the Other Side shall be exempt from tax (which, in the case of the Mainland of China, includes Business Tax) on the Other Side". Here, the terms "enterprise of One Side" and "enterprise of the Other Side" mean respectively an enterprise carried on by a resident of One

12. Art. 7 of the Arrangement also provides that "No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise".
13. See Chan, Kwok Ki, "China: Taxation of Representative Offices", 10 *Asia-Pacific Tax Bulletin* 8 (2004).

Side and an enterprise carried on by a resident of the Other Side.[14]

There is a difference between profits not liable to tax and profits exempted from tax. A person is not required to pay tax whether he is not liable to tax or exempted from tax. Profits liable to tax and profits not liable to tax are mutually exclusive. Profits exempted from tax means the government of a country has the power to impose tax on the profits under the law in the first place, but the government waives this power to tax or excludes the profits from tax under the specific provisions of the law.

3.3. Conflict between sources

Source-source conflict results from claims by two taxing jurisdictions to impose tax on the income arising from the same business activities performed according to their respective source rules.

Example 1

Double taxation occurs where a Hong Kong employer assigns an employee to work in China on a permanent basis. China's tax law imposes tax on the Hong Kong employee because the employment is exercised in China.[15] In Hong Kong, Sec. 8(1) of 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. The double taxation could have been avoided if the salaries tax is imposed on employment exercised in Hong Kong, but not on employment *with* a Hong Kong company.

In the absence of a bilateral agreement, 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. The Hong Kong employee who had paid tax on income derived from employment performed in China may rely on Sec. 8(1A)(c) of the IRO to claim exemption from Hong Kong salary tax.[16] Note that the exemption is granted unilaterally to Hong Kong employees whether or not they are residents in Hong Kong. Note also that Sec. 8(1) of the IRO is inconsistent with Sec. 14 of the IRO in that Sec. 8(1) oversteps the territorial principle by imposing tax on the Hong Kong employment, which may be exercised inside or outside Hong Kong.

Example 2

A Hong Kong company engaged in television business obtains a licensing right for a film from its Hong Kong holding company. Then suppose this Hong Kong television company sub-licenses its right to a non-Hong Kong party for use in Singapore. The Hong Kong television company will be liable to taxes on the royalty fee received from the sub-licensee on the grounds that it carries on a licensing and sub-licensing business in Hong Kong and the profits are derived from that business in Hong Kong under Sec. 14 of the IRO.[17] In Singapore, the income is liable to tax under the charging provision of the Singaporean income tax legislation since the sub-licensing right is exercised in Singapore.[18] Note that the double taxation could have been avoided if the Hong Kong holding company had transferred the intellectual property (IP) rights to the Hong Kong television company before it granted the IP rights to the licensee situated outside Hong Kong. The tax implication after the change of IP rights ownership will be that the rights are now exercised outside Hong Kong, therefore the royalty income is not liable to Hong Kong tax. The transfer of a capital asset (i.e. film rights) does not give rise to Hong Kong profits tax liability for the Hong Kong holding company.[19] The source rules can be circumvented and taxes avoided given that the taxpayer can structure the transaction in ways so that the activities that generate the profits all take place outside Hong Kong.

4. The "Income Tax Arrangement" between Hong Kong and China

The existence of double taxation shows that Hong Kong is in need of tax treaties and concluding such treaties with its trading partners is beneficial for Hong Kong. Politically Hong Kong is part of China and as such, instead of a tax treaty, the governments of the two sides signed "An Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion" (the Arrangement) on 21 August 2006.[20] The previous Arrangement which had been signed between the two sides on 11 February 1998 was repealed on 1 January 2007. It should be noted that the operation of Hong Kong's tax rules and the Arrangement can result in double non-taxation and this point is illustrated by examining the provision of services, employment and sale of goods.

4.1. Service income

Suppose a Hong Kong company sends its employees to perform installation work including equipment testing and the training of local workers, for a piece of equipment at the client's factory in China. In accordance with Hong Kong's tax rules, this Hong Kong company is not liable to Hong Kong profits tax.[21] Under Chinese tax laws, the Hong Kong company has derived income from within China since the installation activities giving rise to the profits are performed in China. The client situated in China is obliged to withhold income tax from payments to be made to the Hong Kong company and remit the withheld tax to the Chinese tax authorities.[22] This is the general practice for tax collection and foreign exchange compliance in China, in the absence of the Arrangement.

14. See Art. 3(6) of the Arrangement.
15. See Art. 5 of the Implementation Regulation of the Chinese Individual Income Tax Law, promulgated by the State Council and effective on 1 January 2006.
16. Sec. 8(1A)(c) of the Hong Kong Inland Revenue Ordinance (IRO) was enacted in 1987. Art. 7 of the Chinese Individual Income Tax Law provides a unilateral credit to relieve residents of China from tax suffered for employment performed outside China.
17. See the Privy Council decision in *Commissioner of Inland Revenue v. HK-TVB International Limited*, 1 Hong Kong Revenue Case (1992).
18. Under Sec. 10(1) of the Singapore Income Tax Act (SITA), the income of any person accruing in or derived from Singapore or received in Singapore from outside Singapore shall be liable to tax in Singapore unless such income has otherwise been exempt from tax under the SITA.
19. See Sec. 14 of the IRO, Chap. 112 of the Law of Hong Kong.
20. The Arrangement comes into effect on 1 January 2007 in the Mainland of China, and on 1 April 2007 in Hong Kong.
21. Sec. 14 of the IRO provides that "Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part".
22. See Art. 29 of Chinese Tentative Business Tax Regulation, promulgated by the Ministry of Finance on December 1993. The amount of withholding tax is 20% on the gross payment after deducting the business tax. That is, (100 – 5) x 20% = 19 given a total service fee of RMB 100.

Art. 7 of the Arrangement (Art. 1 in the former version) specifically provides that "the profits of an enterprise of One Side shall be taxable only on that Side unless the enterprise carries on business on the Other Side through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed on the Other Side but only so much of them as is attributable to that permanent establishment." The Arrangement allocates the taxing rights between the two sides on the profits derived by the resident of one side from the other side with reference to the duration of the business activities performed.

In accordance with the Arrangement, where the Hong Kong company delivers the installation and related services in the Mainland of China for a period of less than six months, it has no PE in China and is entitled to tax exemption. The Hong Kong company has to report the amount of service income derived from activities performed in China in the financial statements. When the Hong Kong company prepares the tax computation, it is entitled to exclude the service income from the taxable income since it does not fall into the scope of Hong Kong profits tax. Due to the operation of Hong Kong domestic tax rules and the Arrangement, the Hong Kong company ends up paying no tax in both tax jurisdictions. The provision of the Arrangement shall also apply to the provision of services in China by Hong Kong individual service providers. As a separate but related matter, if the Hong Kong company structures a contract for royalty income as a contract for the provision of technical and management services in China, the Hong Kong company will not be liable for tax in both jurisdictions.

4.2. Employment

The Arrangement provides that remuneration derived by Hong Kong employees from China is exempted from Chinese individual income tax (IIT) if the following conditions are met:

- the recipient stays in the other side (i.e. China) for a period or periods not exceeding in the aggregate 183 days in the calendar year concerned;
- the remuneration is paid by, or on behalf of, an employer who is not a resident of the other side (i.e. China); and
- the remuneration is not borne by a PE or a fixed base which an employer has on that other side (i.e. China).[23]

Here the wording contains a loophole since "the employer who is not a resident of Mainland China" can be a Hong Kong company or can be a company in a third jurisdiction including one created in a tax haven like the British Virgin Islands (BVI). If the Hong Kong employee is hired by a BVI company to work in China for a period of not exceeding six months in the calendar year, the tax implication will be the employee being exempted from Chinese IIT and in Hong Kong, the employee not being liable to salaries tax since he/she is not hired by a Hong Kong company nor worked in Hong Kong for that period.

4.3. Trading profits

According to a Practice Note issued by the Hong Kong Inland Revenue Department and a decision of the Hong Kong Courts, profits arising from the sale of goods are derived as a result of activities performed by the taxpayer, such as:

- pre-contract negotiations leading to the conclusion of the sales contract;
- activities performed relating to the execution of the sales contract; and
- activities relating to the performance of the obligation under the contract.[24]

Sec. 14 of the IRO specifically provides that the taxpayer is liable for profits tax if the above-mentioned activities are performed in Hong Kong. Where the activities are carried out by the taxpayer partially in Hong Kong and partially outside Hong Kong, the trading profits are still taxable in Hong Kong. Where the taxpayer carries out all of the above activities outside Hong Kong, the trading profits are not taxable in Hong Kong. This is because Hong Kong tax laws only impose tax on profits derived from within Hong Kong. Non-residents can establish a Hong Kong company, and shift the trading profit to it through re-invoicing transactions conducted in accordance with the arm's length pricing principles.

There are several reasons for doing this. First, the Hong Kong company, which is incorporated in Hong Kong, is not required under the Hong Kong law to carry on business activities within Hong Kong or to locate its management and control centre in Hong Kong. Secondly, Hong Kong company laws impose no requirement that the shareholder(s) or director(s) of the Hong Kong company must be Hong Kong resident(s). Thirdly, Hong Kong company laws only require a minimum paid-up capital of HKD 1, and finally, Hong Kong imposes no turnover taxes and exchange control. Therefore, the use of a Hong Kong company for re-invoicing purposes is feasible both in law and practice to residents of China and other jurisdictions.

In determining whether income is Hong Kong sourced or non-Hong Kong sourced, Hong Kong Courts apply the principle that, "... one looks to see what the taxpayer has done to earn the profit, and where he has done it".[25] Some Hong Kong Court decisions on the locality of trading profits have provided authoritative guidance for taxpayers to follow at the operational level.[26] A Hong Kong company should structure its business activities in the manner shown in Table 4.

23. See Art. 14(2) of the Arrangement.
24. See Departmental Interpretation and Practice Note No. 21, issued by the Hong Kong Inland Revenue Department.
25. See *Commissioner of Inland Revenue v. Hang Seng Bank Ltd.*, 1 Hong Kong Revenue Case (1990), and *Commissioner of Inland Revenue v. HK-TVB International Limited*, 1 Hong Kong Revenue Case (1992).
26. See *Commissioner of Inland Revenue v. Magna Industrial Co. Ltd*, Hong Kong Revenue Case (1997), and *Commissioner of Inland Revenue v. Consco Trading Co. Ltd.*, Hong Kong Revenue Case (2004).

Table 4

Where do the activities take place?	Will they attract Hong Kong tax?
All the purchases and sales activities take place in Hong Kong.	If yes, tax obligation arises.
Some of the purchase and sales activities take place in Hong Kong.	If yes, tax obligation arises.
Either purchase or sales activities take place in Hong Kong.	If yes, tax obligation arises.
Either the supplier or the customer is a Hong Kong company.	If yes, tax obligation arises.
Whether the Hong Kong company obtains banking facilities in Hong Kong to provide trade finance to the transaction	If yes, tax obligation arises.
All the purchase and sales activities take place outside Hong Kong; and neither suppliers nor customers are Hong Kong companies.	If yes, no tax obligation arises, subject to all above conditions being met.

In addition to the above principal business process, the taxpayer should consider the following relevant matters in connection with the trading transactions:

- the insurance contract;
- the transportation contract;
- the place where instructions for preparing invoices are given;
- the employment of staff and maintenance of an office in Hong Kong; and
- whether there is a resident agent in Hong Kong.

The Hong Kong tax authorities need to obtain detailed information on every stage in the business transaction to determine whether the activities all take place outside Hong Kong from which the trading profit is generated. Where the facts relating to offshore activities are confirmed between the Inland Revenue Department and the taxpayer, the profit is not liable to profits tax.[27]

5. Interaction between Sec. 14 of the IRO and the Arrangement

The Arrangement is intended to avoid double taxation on the income by the tax authorities both in Hong Kong and China. The new version of the Arrangement expands the scope to the prevention of fiscal evasion. Both the current Arrangement and its predecessor contain a taxing gap, resulting in no taxation or double non-taxation. The new Arrangement transplants a residence concept into the Hong Kong tax system. The gap arises from the fact that the drafters of the Arrangement mistakenly considered Sec. 14 of the IRO, which follows the source principle, to be the one which follows the residence principle. This has resulted in taxpayers in Hong Kong and China taking advantage of the loophole in the Arrangement.

5.1. The structure of Sec. 14 of the IRO

It is useful to compare the structure of Sec. 14 of the IRO, which is the basic charging provision for tax on trade, profession and business profits, with the provision for tax on shipping profits (Secs. 23B(1) and 23B(2) of the IRO), the provision for tax on profits of an aircraft operator (Secs. 23C and 23D of the IRO), and the provision for tax on employment income (Sec. 8 of the IRO).

Sec. 14 of the IRO provides that "Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part". An analysis of the structure of Sec. 14 of the IRO shows us that:

- Hong Kong tax liability arises if two conditions are met, i.e. (i) carrying on trade, profession or business in Hong Kong, and (ii) profits arising in or derived from Hong Kong from that trade, profession or business. The tax rule looks at the profit-generating activities a person performs in Hong Kong;
- it establishes a nexus between Hong Kong and the activities that generate the profits. The residence of a person is not relevant to Sec. 14 of the IRO;
- it makes a distinction between the activities performed within and outside Hong Kong. Sec. 14 of the IRO does not impose tax on the profit-generating activities if they take place outside Hong Kong; and
- it does not exercise any extraterritorial sovereignty over a person carrying on trade, professional or business in Hong Kong. Profits derived from outside Hong Kong are not taxable even if they are received in Hong Kong (see Table 5).

Table 5

	Carrying on trade, profession, or business in Hong Kong	Carrying on trade, profession, or business outside Hong Kong
Profits arising in or derived from Hong Kong	Yes, it is taxable under Sec. 14 of the IRO.	It is not taxable under Sec. 14, but taxable under Sec. 15 of the IRO.
Profits arising or derived from outside Hong Kong	Not liable to tax.	Not liable to tax.

27. If both parties disagree on matters of fact, either party can bring the case to the Inland Revenue Board of Review for determination under Sec. 66 of the IRO. If both parties disagree on matters of law, then either party can take the case to the Hong Kong Courts under Sec. 67 of the IRO. Where the views of the Inland Revenue Board of Review differ from that of the Courts on the source of trading profits, the decision of the Courts shall be final and conclusive. See Sec. 69 of the IRO.

Note that if a non-resident earns a Hong Kong-sourced income, the profits are subject to tax under Secs. 15(1)(a), 15(1)(b) and 15(1)(d) of the IRO respectively.[28]

Where a person carrying on business in Hong Kong earns a profit from activities taking place outside Hong Kong, the profits are not subject to tax.[29] In contrast, Singaporean tax law imposes tax on Singapore-sourced profits, and profits derived from outside Singapore when they are received in Singapore.[30] Depending on the domestic tax rules, foreign-sourced income may also be subject to tax at the home jurisdiction on an "as-earned" basis.[31]

Tax rules on the profits of aircraft operators

Table 6

Resident Aircraft Operator	Non-Resident Aircraft Operator
Sec. 23C of the IRO[1]	**Sec. 23D of the IRO[2]**
(1) Where a person carries on a business as an owner of aircraft and – (a) the business is normally controlled or managed in Hong Kong; or (b) the person is a company incorporated in Hong Kong, that person shall be deemed to be carrying on that business in Hong Kong.	(1) ... where a person to whom section 23C does not apply carries on a business as an owner of aircraft, and any aircraft owned by that person lands at any aerodrome or airport within Hong Kong, that person shall be deemed to be carrying on that business in Hong Kong.
Profit is subject to tax under Sec. 23C(2) of the IRO.	Profit is subject to tax under Sec. 23D(2) of the IRO.

1. Sec. 23C(2) of the IRO provides that "... where a person is deemed to be carrying on a business as an owner of aircraft in Hong Kong under this section the assessable profits from that business for any year of assessment shall be the sum bearing the same ratio to the aggregate of the relevant sums earned by or accrued to that person during the basis period for that year of assessment as that person's total aircraft profits for the basis period bear to the aggregate of the total aircraft income earned by or accrued to that person during that the basis period for that year of assessment."
2. Sec. 23D(2) of the IRO provides that "... where a person is deemed to be carrying on a business as an owner of aircraft under this section the assessable profits of that person from that business for any year of assessment shall be the sum bearing the same ratio to the aggregate of the relevant sums earned by or accrued to that person during the basis period for that year of assessment as that person's total aircraft profits for the basis period bear to the aggregate of the total aircraft income earned by or accrued to that person during that basis period for that year of assessment."

Secs. 23C and 23D of the IRO carry a deeming provision and deal with resident and non-resident aircraft operators respectively (see Table 6). It is useful to compare the tax rules under Secs. 14 and 23C of the IRO. Sec. 23C of the IRO is not concerned with what the taxpayer does but looks at the place of incorporation, and if it is not incorporated in Hong Kong, the place of management and control is used instead. Sec. 14 of the IRO, on the other hand, looks at the profit-generating activities that a person performs, i.e. what they do to earn the profits in question and where such activities are carried out. If the aircraft operator is a Hong Kong company, it is liable to tax in accordance with Secs. 23C(1) and 23C(2) of the IRO. If the aircraft operator is a non-Hong Kong company but it is controlled or managed in Hong Kong, it is also liable to tax in accordance with Sec. 23C(1) and 23C(2) of the IRO. Sec. 23D of the IRO provides the tax rules for non-resident aircraft operators, whereby the person is liable to Hong Kong profits tax if any aircraft owned by that person lands at any aerodrome or airport within Hong Kong. In comparison with Sec. 14 of the IRO, Secs. 23C and 23D work together and leave nothing in between. Since international transportation businesses operate between Hong Kong and non-Hong Kong territories, Secs. 23C and 23D of the IRO exercise extraterritorial jurisdiction.

Tax rules on shipping profits

Sec. 23B of the IRO follows the same principle as the provision for tax on the air service income under Secs. 23C and 23D of the IRO. Sec. 23B of the IRO provides that:

- where a person carries on a business as an owner of ships and (i) the business is normally controlled or managed in Hong Kong, or (ii) the person is a company incorporated in Hong Kong, that person shall be deemed to be carrying on that business in Hong Kong; and
- where a person to whom the above condition does not apply carries on a business as an owner of ships, and any ship owned by that person calls at any location within the waters of Hong Kong, that person shall be deemed to be carrying on that business in Hong Kong.

Employment income

Sec. 8(1) of 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 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. Sec. 8(1) of the IRO provides one limb, i.e. the

28. Sec. 15(1)(a) of the IRO reads, "... sums, not otherwise chargeable to tax under this Part, received by or accrued to a person from the exhibition or use in Hong Kong of cinematograph or television film or tape, any sound recording, or any advertising material connected with such film, tape or recording". Sec. 15(1)(b) of the IRO reads, "... sums, not otherwise chargeable to tax under this Part, received by or accrued to a person for the use of or right to use in Hong Kong any patent, design, trademark, copyright material, secret process or formula or other property or a similar nature, or for imparting or undertaking to impart knowledge directly or indirectly connected with the use in Hong Kong of any such patent, design, trademark, copyright material, secret process or formula or other property". Sec. 15(1)(d) of the IRO reads, "... sums received by or accrued to a person by way of hire, rental or similar charges for the use of movable property in Hong Kong or the right to use movable property in Hong Kong ...."

29. See *Commissioner of Inland Revenue v. Hang Seng Bank Ltd.*, 3 HKTC 360, *Commissioner of Inland Revenue v. the Hong Kong Whampoa Dock Company Limited* 1 HKTC 85 (1960), and *Commissioner of Inland Revenue v. Consco Trading Co. Ltd.*, Hong Kong Revenue Case (2004).

30. See Sec. 10(1) of the SITA.

31. Canadian tax law imposes tax on a resident in respect of the earnings of a foreign company if this company is engaged in earning passive income like interest and dividend. The Canadian tax resident can defer the tax liability at home for the earnings of the foreign company if it earns an active income.

employment with a Hong Kong company, while Sec. 8(1A) of the IRO provides the other limb, i.e. an employee hired by a non-Hong Kong company is also liable to salaries tax if the employment is exercised in Hong Kong.[32] The employee can exercise employment inside or outside Hong Kong. In comparison with Sec. 14 of the IRO, Sec. 8(1) exercises an extraterritorial jurisdiction if the employee of a Hong Kong company performs his/her duty outside Hong Kong. Sec. 8(1A) of the IRO was enacted to fill the gap left by Sec. 8(1) (i.e. to prevent the non-taxation of an employee who exercises employment in Hong Kong if he/she is hired by a non-Hong Kong company).

6. Comparison

A summary may help recapitulate the differences (see Table 7).

Table 7

	Both non-Hong Kong source and Hong Kong source income	Non-Hong Kong source income only
Employment income	Sec. 8(1)	Sec. 8(1A)
Air service income	Sec. 23C	Sec. 23D
Shipping income	Sec. 23B(1)	Sec. 23B(2)
Business profits	N/A	Sec. 14

Art. 4 of the Hong Kong–Belgium tax treaty gives the definition of residence. It reads as,

> For the purpose of this Agreement, the term "a resident in a Contracting Party" means any person who, under the laws in force in that Party, is liable to tax therein by reason of his domicile, residence, place of management or incorporation or any other criterion of a similar nature, ... This term, however, does not include any person who is liable to tax in that Party in respect only of income from sources in that Party or capital situated therein.

The taxation of employment income under Sec. 8 of the IRO does not work in line with the residence concept. Sec. 8 of the IRO makes a distinction between income derived from Hong Kong employment and non-Hong Kong employment. The taxation of business profits under Sec. 14 of the IRO bears no relationship with residence. Sec. 14 of the IRO only targets income of a person with a Hong Kong source. The person as defined in Secs. 8 and 14 of the IRO has been excluded under Art. 4 of the Hong Kong–Belgium tax treaty, and thus, Art. 4 does not apply.

Art. 4 of the Hong Kong–Thailand tax treaty gives another definition of residence. It reads as,

> For the purposes of this Agreement, the term "resident of a Contracting Party" means: (a) in the case of Hong Kong Special Administrative Region (i) any individual who ordinarily resides in Hong Kong SAR; (ii) any individual who stays in the Hong Kong SAR for more than 180 days during a year of assessment or for more than 300 days in two consecutive years of assessment one of which is the relevant year of assessment; (iii) a company incorporated in the Hong Kong SAR or, if incorporated outside the Hong Kong SAR, being normally managed or controlled in the Hong Kong SAR ...

It does not help because (i) the provision of a specific requirement for residence bears no relationship to the liability for salaries tax under Sec. 8 of the IRO, and (ii) Sec. 14 of the IRO does not impose profits tax on a person, but on the activities of a person. Therefore, Art. 4 of the Hong Kong–Thailand tax treaty does not apply either.

The Commentary on Art. 4 of the OECD MC gives the definition of resident in a very much concise way, i.e.

> Generally the domestic law of the various States impose a comprehensive liability to tax – "full tax liability" – based on the taxpayers' personal attachment to the State concerned (the "State of residence"). This liability to tax is not imposed only on persons who are "domiciled" in a State in the sense in which "domicile" is usually taken in the legislations (private law). The cases of full liability to tax are extended to comprise also, for instance, persons who stay continually, or maybe only for a certain period, in the territory of the State ...; Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as "resident" and, consequently, is fully liable to tax in that State.[33]

7. Conclusion

Sec. 14 of the IRO only has one limb, i.e. profits are liable to tax if it is derived from Hong Kong from a trade, profession or business carried on in Hong Kong by a person. The other limb, profits are liable to tax if derived from outside Hong Kong and received in Hong Kong, is absent in the IRO. To develop a network of comprehensive tax treaties, the scope of Sec. 14 of the IRO has to be expanded to include the other limb. The tax laws in Singapore could provide for a reference since Singapore has concluded a network of comprehensive tax treaties with her trading partners.

In Singapore, a tax resident is liable to tax on income derived from Singapore and income received in Singapore from outside Singapore.[34] As long as Hong Kong only taxes Hong Kong-sourced profits, it will have difficulty in concluding comprehensive tax treaties with its major trading partners except on certain categories of income such as shipping and air services. Until the offshore income of a person who carries on business in Hong Kong is brought within the Hong Kong tax net, Hong Kong could be considered a tax haven within the context of Sec. 14 of the IRO.

32. Sec. 8(1A) of the IRO provides that "For the purposes of this Part, income arising in or derived from Hong Kong from any employment includes ... all income derived from services rendered in Hong Kong including leave pay attributable to such services."
33. See Paras. 3 and 4 of the Commentary on Art. 4 concerning the definition of resident in the "Commentary on the Articles of the 2003 OECD Model Income and Capital Tax Convention", published on 28 January 2003.
34. See Sec. 10(1) of the SITA.

The IRO came into effect in 1947 and has remained basically the same regarding the major charging provisions.[35] Hong Kong's tax system has not been developing at the same pace as the economy in the past, during which the Hong Kong economy has evolved from a local manufacturing centre, through a trading centre, to a finance centre for Greater China and Asia. Hong Kong is a free port where the administration does not impose any restrictions on the cross-border movement of money, goods, and capital. Concluding tax treaties with the trading partners has been an item on the agenda for the Hong Kong government policymakers for some years. But the limitation inherent in Sec. 14 of the IRO has defeated the purpose of concluding comprehensive tax treaties. The adoption of tax on worldwide income has three advantages for Hong Kong. Firstly, it will help widen Hong Kong's narrow tax base. Secondly, it can close the tax gap and rid Hong Kong of its tax haven image. Finally, it can sign a full version tax treaty with major trading partners.[36]

35. The IRO provides that it is enacted "... to impose a tax on property, earnings and profits", Chap. 112 of the Laws of Hong Kong.
36. The territorial tax base is shrinking over time since profits from offshore business activities and investment are not subject to tax in Hong Kong. That is working in the opposite direction for the Hong Kong government to achieve a balanced fiscal budget in Hong Kong, which is prescribed under Art. 107 of the Basic Law of Hong Kong Special Administrative Region. Much has been talked about Hong Kong having a narrow tax base. Goods and service tax (GST), tax on capital gains, tax on dividend, and tax on worldwide income have been put forward in order to provide a solution to the narrow tax base.