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Tax Alert

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Development of Hong Kong's double tax treaty network and implications on China inbound investment structures

Hong Kong has long been recognized as one of the world's leading financial centers with its advanced infrastructure, sophisticated legal system and open business environment. It also has a well-established international arbitration center (The Hong Kong International Arbitration Centre or "HKIAC") which is recognized as Asia's leading international dispute resolution service provider.

Nevertheless, Hong Kong was not previously considered an ideal location for establishing a regional headquarters in Asia. Before 2010, Hong Kong has only concluded comprehensive double taxation agreements / arrangements ("DTAs") with 5 jurisdictions, namely Mainland China, Belgium, Luxembourg, Thailand and Vietnam. However, following the G20 summit held in 2009, the Hong Kong Government was under pressure to enter into more tax treaties in support of international efforts to enhance tax transparency. By 1 August 2012, Hong Kong has made significant progress in broadening its treaty network with a total of 25 comprehensive DTAs signed and a number of DTAs under negotiation. The extended DTA network has considerably enhanced Hong Kong's appeal as an international investment hub for regional and global businesses/ organizations.

The following table summarizes the development of Hong Kong's comprehensive DTA up to 1 August 2012:

Countries that have signed Comprehensive DTAs with Hong Kong	Countries under discussion to sign Comprehensive DTAs with Hong Kong
Austria, Belgium, Brunei, Czech, France, Hungary, Indonesia, Ireland, Japan, Liechtenstein, Luxembourg, Mainland of China, Netherlands, New Zealand, Portugal, Spain, Thailand, United Kingdom, Vietnam, Malaysia, Malta, Mexico, Switzerland, Jersey, Kuwait	Bangladesh, Canada, Finland, Guernsey, India, Italy, Korea, Macau, Saudi Arabia, United Arab Emirates
Total: 25 jurisdictions	Total: 10 jurisdictions

This article provides a general overview of how investors may capitalize on the DTA network of Hong Kong to structure their China inbound investments within the ambit of the general anti-avoidance provisions and beneficial ownership requirements set by the tax authorities in Mainland China.

Although many foreign countries have concluded DTAs with Mainland China, most of their terms governing withholding tax rates on passive income, including dividends, interest, royalties, and capital gains, are not as favourable as those under the DTA between Mainland China and Hong Kong. According to the new Enterprise Income Tax ("EIT") Law effective from 1 January 2008, the general withholding tax rate in Mainland China is 10%. However, the DTA between Mainland China and Hong Kong provides for reduced tax rates as summarized in the table below:

	From PRC to HK
Dividend	5% (note 1)
Interest	7% (note 2)
Royalties	7%
Capital gains	0%/10%(note 3)

Note 1:
The 5% rate applies if the beneficial owner is a company directly owning at least 25% of the registered capital of the company that pays the dividends with a holding period of not less than 12 months; otherwise 10% applies.

Note 2:
The 0% rate only applies to interest received by the Hong Kong Government or recognized institutions; otherwise 7% applies.

Note 3:
The 10% withholding tax rate applies to gains derived from direct or indirect transfer of immovable properties and shares of company with assets principally comprising of immovable property in the PRC or shareholding of at least 25% at any time within 12 months before the alienation. The 0% rate applies to other cases.

In addition to the favourable DTA between Mainland China and Hong Kong, one of Hong Kong's attraction as a regional headquarters is its simple tax system. Hong Kong adopts a territorial basis of taxation, where only profits arise in or derived from within the territory of Hong Kong will be subject to profits tax. Under the Hong Kong tax system, no tax is imposed on dividends repatriated from overseas subsidiaries or distributed to overseas parents. Likewise, interest income derived from overseas companies is generally not subject to Hong Kong profits tax if the place where the credit provided to the borrower (i.e. the place where the funds from which the interest derived were provided to the borrower) is not in Hong Kong. In relation to royalties received by a Hong Kong company, such income could be subject to Hong Kong profits tax rate of 16.5%. For royalty payments made by a Hong Kong company, a withholding tax could be imposed at a rate of 16.5% (for royalty payments due to a non-resident company that is an associate of the

Hong Kong entity) or 4.95% (if the Inland Revenue Department is satisfied that "no person carrying on a trade, profession or business in Hong Kong has at any time wholly or partly-owned the relevant intellectual property"). There is also no capital gains tax in Hong Kong. The extended treaty network of Hong Kong further provides added incentives for foreign investors to invest into Mainland China through Hong Kong as a regional headquarters, especially if they come from jurisdictions that have not signed any DTAs or signed less favourable DTAs with Mainland China. In this connection, Hong Kong may not only serve as a capital investment hub but also a gateway for establishing financing arrangements to Mainland China.

For example, in February 2012, Hong Kong concluded a comprehensive DTA with Jersey, which is also one of the world's premier financial centers. Backed by an attractive taxation regime, Jersey does not impose tax on capital gains and its income tax rate is significantly lower than that of the UK despite of its proximity with the UK. Jersey resident companies or non-Jersey resident companies (subject to exceptions, as illustrated below) that have permanent establishments in Jersey are subject to corporate income tax at 0%. Jersey companies that meet the definition of a "financial services" company are subject to corporate income tax at a rate of 10% whereas those that meet the definition of "utility company" are subject to a 20% corporate income tax rate. However, Jersey does not have any comprehensive DTA with Mainland China as of 1 August 2012. Since Jersey holding companies enjoy favourable tax treatments and have flexible company structures, they have become popular vehicles for listing around the world and can be found in major stock markets including Amsterdam, London, New York, Stockholm, Toronto and even Hong Kong. With the new DTA concluded between Hong Kong and Jersey, there are opportunities to explore the benefits offered under the new DTA for inbound China investment.

The table below shows the withholding tax rates for repatriation from the PRC through a regional headquarters in Hong Kong versus direct repatriation from the PRC to Jersey:

	From PRC to HK	From HK to Jersey	From PRC to Jersey
Dividend	5% (note 1)	0%	10%
Interest	7% (note 2)	0%	10%
Royalties	7%	4%	10%

In addition to Jersey, Hong Kong has concluded a number of new comprehensive DTAs from 2010 to 1 August 2012. While these countries may have DTAs with China, there are still opportunities to leverage the benefits under the more favourable DTA between Hong Kong and China by setting up a Hong Kong regional headquarters.

The table below shows the withholding tax rates for repatriation from the PRC through a regional headquarters in Hong Kong versus direct repatriation from the PRC to the UK/ Netherlands/Luxembourg:

	From PRC to HK	From HK to UK	From PRC to UK*
Dividend	5% (note 1)	0%	5% (note 5)
Interest	7% (note 2)	0%	10%
Royalties	7%	3%	10% or 6% (note 4)

** The new DTA between China and the UK was signed on 27 June 2011 and was not effective as of 1 August 2012. It will enter into force when both countries have completed their legislative procedures.*

	From PRC to HK	From HK to Netherlands	From PRC to Netherlands
Dividend	5% (note 1)	0%	10%
Interest	7% (note 2)	0%	10%
Royalties	7%	3%	10% or 6% (note 4)

	From PRC to HK	From HK to Luxembourg	From PRC to Luxembourg
Dividend	5% (note 1)	0%	10%
Interest	7% (note 2)	0%	10%
Royalties	7%	3%	10% or 6% (note 4)

Note 4:
The 6% rate applies to payment received for the use of, or the right to use, industrial, commercial, or scientific equipment.

Note 5:
The 5% rate applies if the beneficial owner is a company which holds directly or indirectly at least 25% of the capital of the company paying the dividends.

As illustrated above, the use of a Hong Kong regional headquarters for China inbound investment could enhance tax efficiency, subject to satisfaction of the beneficial ownership test in Mainland China as set out under Guoshuihan [2009] No. 601 ("Circular 601"). Under Circular 601, a beneficial owner refers to a person or any organization that has the ownership right and control right of the income, or the right or property from which the income is derived. Agents and conduit companies that are set up for the purpose of tax avoidance or minimization, or profits shifting or accumulating are not considered as beneficial owners. The Mainland Chinese tax authorities apply the "substance over form" principle to evaluate whether an enterprise is involved in a tax avoidance arrangement and in determining the beneficial ownership.

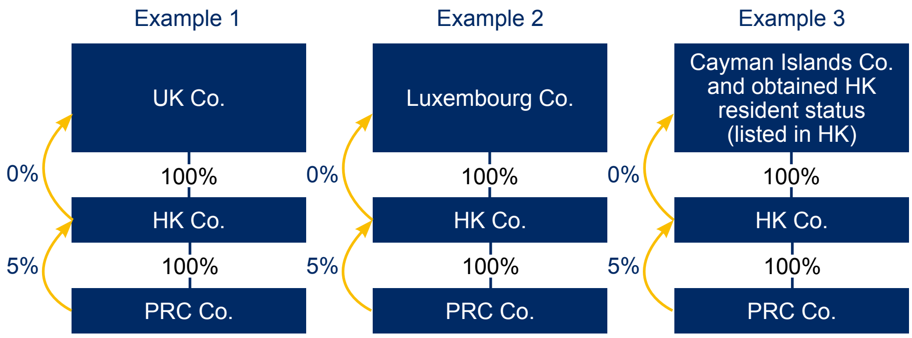
On 29 June 2012, the State Administration of Taxation ("SAT") in China issued the long awaited supplementary rule to Guoshuihan [2009] No.601 ("Circular 601") to provide clarification on Determining Beneficial Ownership for the enjoyment of PRC Double Tax Treaty Benefits in respect of dividend, interest and royalty income etc (hereinafter referred to as "passive income") derived from China. The supplementary rule, i.e. Bulletin [2012] No.30 ("Bulletin 30"), took effect from 29 June 2012. It addresses a number of technical and practical issues for implementation that were not previously covered in Circular 601.

Pursuant to Bulletin 30, the SAT confirmed that the determination of whether beneficial ownership exists should depend on a collective assessment of a totality of factors set out in Circular 601. In this regard, no single or specific negative factor could override or outweigh other factors. The lack of tax avoidance motive (e.g. to escape or reduce tax, transfer or accumulate profits etc) cannot be used as an argument to refute or deny the application of the totality of factors assessment. Bulletin 30 emphasizes the importance of reviewing various financial and legal documentations for conducting an analysis of beneficial ownership status.

In relation to relief for dividend repatriation, Bulletin 30 introduces a new safe harbour provision for dividends distributed to listed companies, thereby permitting qualified listed companies having direct or indirect equity interest in PRC subsidiaries to be granted beneficial ownership status directly for treaty tax relief claims for dividends. According to Bulletin 30, an applicant from a treaty jurisdiction could be directly recognised as a beneficial owner if it is a tax resident and listed company from that treaty jurisdiction or is 100% directly or indirectly held by a listed company located in that treaty jurisdiction, provided that there is no intermediate company which is a resident of a third party country or region interposed between the listed company and the Chinese resident company that distributes the dividend income. Where a treaty resident derives China-sourced passive income through an agent or a designated person, Bulletin 30 also provides measures that allow self-declaration being made by the genuine agent or designated person such that relevant treaty benefits could be granted to the true beneficial owner. For more details in relation to Bulletin 30, please refer to our China Alert Issue 6.

A practical approach for investors to justify the holding company as the beneficial owner is to align the business scale and size (taking into account various aspects such as assets, employees, investments and operations) wherever feasible with the income received by the holding company. These may include structuring reasonable amount of capital and assets, employees capable of undertaking the appropriate functions, contractual rights and maintaining a physical office. In addition to building adequate, reasonable and genuine substance, care should be exercised to ensure that the structure has genuine commercial purpose and not primarily tax driven.

We set out below some examples of using Hong Kong as a regional headquarters and the related tax implications on dividend repatriation:



In the above examples, 5% withholding tax would apply to dividend repatriation from a PRC subsidiary if the Hong Kong regional headquarters satisfies the beneficial ownership test and has fulfilled the filing requirements under Guoshuifa [2009] No.124.

In example 1, if the Hong Kong regional headquarters does not satisfy the beneficial ownership requirement and is only a genuine nominee or agent (provided that the requirements are met and the procedures are followed), a declaration may be made under Bulletin 30 such that the UK parent can claim itself as the true beneficial owner. Under the new DTA between China and the UK, a 5% withholding tax may apply to dividend repatriation from China to the UK. The Hong Kong regional headquarters may carry on business activities (e.g. trading/servicing) and is subject to profits tax at a rate of 16.5% if the profits arise in or are derived from Hong Kong. For the conduit companies which are not legally and genuine agents or nominees, Bulletin 30 does not provide clear guidelines on the relevant applicability.

In example 2, the Hong Kong regional headquarters should have sufficient substance. Otherwise, a 10% withholding tax applies to dividend repatriated from the PRC subsidiary. The Hong Kong regional headquarters may carry on business activities (e.g. trading/servicing) and is subject to profits tax at a rate of 16.5% if the profits arise in or are derived from Hong Kong.

In example 3, the Hong Kong regional headquarters can be directly recognised as the beneficial owner and claim the benefits under the DTA between China and Hong Kong under Bulletin 30 provided that proper procedures have been followed and requirements are met.

Apart from enhancing tax efficiency, there could be other benefits for setting up a Hong Kong regional headquarters. These may include the provision of more flexibility to facilitate future investment and development or deferral of foreign corporate income tax on dividends distributed from Mainland China until actual repatriation from the intermediate Hong Kong holding company to the foreign parent (subject to the controlled foreign corporation ("CFC") rules if applicable in the jurisdiction where the foreign parent is located).

The new DTAs concluded by Hong Kong provide relief for double taxation for cross-border investments in relevant jurisdictions and create more opportunities for investors to structure their investments through a Hong Kong holding or intermediate holding company. The Organization for Economic Co-operation and Development has also recognized that Hong Kong has adopted the latest international standard of Exchange of Information and has substantially implemented the internationally agreed tax standard (allowing it to qualify as one of the jurisdictions on the so-called "white list"). Investors who would like to leverage the benefits under Hong Kong's DTAs with bona fide commercial/ business purposes should be careful in setting up their investment structure in light of the anti-avoidance provisions under the relevant DTAs, the domestic tax laws, as well as requirements under Circular 601 and Bulletin 30 for China inbound investment. For more information, please contact our tax team.

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