eJournal of Tax Research

Volume 9, Number 3 December 2011
(Special Edition: Double Tax Agreements in the Asia Pacific)

CONTENTS

ISSN 1448-2398

Atax
UNSW

eJournal of Tax Research (2011) vol. 9, no. 3, pp. 247-253

Hong Kong's new tax treaty network

Jefferson Vanderwolk[1]

1. INTRODUCTION

Before the late 1990s, Hong Kong had not entered into any comprehensive tax treaties (also known as double taxation agreements, or DTAs). Hong Kong is a party to numerous treaties in respect of the taxation of airline and shipping income,[2] but, until recently, broader tax treaties were not thought to be necessary, due to the limited and territorial nature of Hong Kong's tax system. Slightly more than ten years on, Hong Kong has entered into twenty-one comprehensive DTAs, most of which have been concluded in the past two years. This is a revolutionary change for a jurisdiction with a tax system so limited that the tax laws (other than treaties) contain, with very few exceptions (relating to special category taxpayers, including ship and aircraft owners and offshore funds), no provisions on the tax residence of either corporations or individuals, and no tax is imposed on foreign-sourced income or on investment income such as dividends, non-business interest, and capital gains.

What has caused the change, and what are its implications for Hong Kong taxation? Part 2 of this article will discuss the background. Part 3 will cover the recent creation of Hong Kong's treaty network and likely developments in this regard. Part 4 will discuss some of the Hong Kong tax issues that are arising, and other issues that may arise, as a result of the treaties.

2. BACKGROUND

The Hong Kong Inland Revenue Ordinance provides for tax to be charged on only three types of income: business profits, income from employment, and rental income from immovable property.[3] Capital gains and other forms of investment income, such as dividends, are exempt from taxation. In addition, the Ordinance provides for a purely territorial tax system: only income arising in or derived from Hong Kong is chargeable to tax. The rates of tax are low. Corporate business profits are taxed at a 16.5 percent rate, and the top rate of tax on individuals is 15 percent.[4]

---

[1] Professor, Chinese University of Hong Kong.

[2] At the time of writing, Hong Kong had signed 37 double tax avoidance agreements regarding shipping or airline income, or both. The complete list of agreements is available at the website of the Hong Kong Inland Revenue Department, www.ird.gov.hk.

[3] Laws of Hong Kong, Cap 112, ss 5, 8, and 14.

[4] These are the rates in effect for the 2010-2011 year of assessment. No change in the rates has been proposed for future years.

In practice, the Hong Kong Inland Revenue Department assesses tax, in certain circumstances, on income that is attributable to activities occurring outside Hong Kong. For example, if an employee has a Hong Kong resident employer, and the employment contract was negotiated and concluded in Hong Kong, all of the income from the employment will be assessed to tax as Hong Kong-sourced income regardless of where the employee's services were rendered, unless the employee can prove that he or she spent no more than 60 days visiting Hong Kong during the year of assessment.[5] Another example: if a Hong Kong-based company purchases products located in a foreign country and sells them to customers in another foreign country, and the products never enter Hong Kong, the resulting profits will generally be assessed to tax as Hong Kong-sourced profits if the authority to conclude the contracts of purchase and sale was exercised by someone in the home office in Hong Kong.[6]

As international business activity expanded in the Asia-Pacific region in the 1970s and 1980s, Hong Kong-incorporated companies began to be used for tax avoidance purposes by investors based in high-tax countries. The combination of a limited tax system, an English legal system, and low-cost, efficient business and banking services performed by English-speaking staff made Hong Kong an unusually attractive location in which to establish an investment holding company or trading company for international business.

For many years, most of the high-tax countries in the world (with the notable exception of the United States) tolerated their residents' use of companies formed in low-tax business and financial centres, even though domestic tax revenue was certainly being lost, or at least deferred, as a result. This complaisant attitude changed gradually. By 1990, nine high-tax countries had enacted controlled foreign company rules (the US first enacted such rules much earlier, in 1962).[7] The Hong Kong government seemed to take no notice of these developments until the 1990s, when a Hong Kong-based lawyer began to call for the government to enter into tax treaties in order to strengthen Hong Kong's competitiveness as an international business and finance centre.[8]

As an example of the problems that could result from having no tax treaties, Marcovici cited the Italian government's inclusion of Hong Kong in a blacklist of tax havens. The blacklist was relevant to anti-avoidance rules denying tax deductions to Italian resident companies for expenses incurred in transactions with companies resident in listed tax havens.[9] This would be sure to discourage Italian companies from doing business with Hong Kong companies. If Hong Kong had had a tax treaty with Italy that provided for reciprocal exchange of information, Hong Kong would not have been placed on the blacklist. Traditionalists scoffed at the idea of Hong Kong entering into tax treaties and agreeing to exchange information, but others could see the value of having treaties with trading partner countries.

---

[5] See Departmental Interpretation and Practice Notes No. 10, available online at the Inland Revenue Department website, www.ird.gov.hk.

[6] See Departmental Interpretation and Practice Notes No. 24 [21?], available online at the Inland Revenue Department website, www.ird.gov.hk.

[7] By 1990, when the Australian rules took effect, controlled foreign company rules had been enacted by the US, the UK, Canada, France, Germany, Japan, and New Zealand.

[8] Philip Marcovici, "Why Hong Kong Should Develop a Tax Treaty Network," *Tax Notes International*, January 1991, at p 95.

[9] Ministerial Decree of 24th April 1992, and Art 110, para 10 of Presidential Decree No. 917.

Meanwhile, the British and Mainland Chinese governments were negotiating the terms of the handover of Hong Kong on 1 July 1997. Three points that emerged from the negotiations were (1) Hong Kong's legal system would continue for at least 50 years, (2) Hong Kong would be independent in financial and tax matters, and (3) Hong Kong would maintain the low-tax policy that it had followed prior to the handover.[10] These matters were decided against a backdrop of rapid economic growth and legal development in the Mainland during the 1990s. Hong Kong's economy was becoming increasingly integrated with that of southern Guangdong province, particularly the manufacturing towns of Shenzhen and Dongguan, where many Hong Kong manufacturing companies had relocated their manufacturing operations.

In these circumstances, it is not surprising that the Hong Kong and Mainland China governments concluded an agreement in 1998 for the avoidance of double taxation.[11] The agreement—which was called an "arrangement" in order to avoid the implication that the two governments were equals—was limited in scope, dealing only with taxable business presence (ie permanent establishments), transportation income, and income from personal services. But it marked a milestone in Hong Kong's tax history: its first DTA applicable generally to individuals and companies from all sectors of the economy.

At around this time, the Hong Kong government decided to pursue DTAs with other countries in an effort to build a worldwide treaty network. Competition with Singapore was undoubtedly a factor in the decision, given the fact that Singapore had a wide network of DTAs already in place. Potential treaty partners were reluctant, however, to conclude DTAs that did not provide for the exchange of information regardless of a domestic tax interest in the information requested.

Between 2004 and 2009, Hong Kong concluded DTAs with four countries:

- Belgium (2004)
- Thailand (2005)
- Vietnam (2009)
- Luxembourg (2009)

In addition, the double tax "arrangement" with Mainland China was expanded and refined, first in 2006 and again in 2008.

A significant change occurred in April 2009, when the G-20 group of nations threatened to punish countries that fail to cooperate in the effective exchange information on tax matters.[12] Failure was defined as having fewer than twelve agreements in place providing for the exchange of information under the terms of Article 26 of the 2004 OECD Model DTA.[13] In conjunction with the G-20's announcement, the OECD Committee on Fiscal Affairs published a list of

[10] Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, Arts 5, 8, 18, 73, 106, and 108.

[11] Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income, available at the website of the Hong Kong Inland Revenue Department, www.ird.gov.hk.

[12] See "Promoting Transparency and Exchange of Information for Tax Purposes: A Background Information Brief," August 10, 2010, available online at www.oecd.org

[13] Ibid

uncooperative countries. At China's request, Hong Kong and Macau were not in the list but were named in a footnote, which stated that they were committed to compliance with the international standard for information exchange and were in the process of amending their laws to permit full compliance in practice.

Soon after these events, the Hong Kong government introduced legislation in June 2009 empowering the Inland Revenue Department to obtain information, pursuant to a request under a DTA, in which it has no domestic tax interest.[14] The legislation was enacted in January 2010, and secondary legislation was passed two months later.[15] Immediately, the Hong Kong government began announcing the conclusion of new DTAs.

3. THE NEW TREATY NETWORK

During 2010 and the first quarter of 2011, Hong Kong concluded new DTAs with the following 16 countries:

- Indonesia
- Brunei
- the Czech Republic
- the Netherlands
- the United Kingdom
- Ireland
- Austria
- France
- Hungary
- Liechtenstein
- Japan
- Kuwait
- New Zealand
- Switzerland
- Spain
- Portugal

In addition, in 2010, Hong Kong concluded treaty protocols with Mainland China and Luxembourg, amending the exchange of information article so as to be consistent with that found in the 2004 OECD model treaty.

Hong Kong continues to work on expanding its treaty network. The HK government is conducting negotiations on new DTAs with:

- Italy
- Finland
- South Korea
- India
- Malaysia
- Malta

[14] Inland Revenue (Amendment) Ordinance 2010, amending Cap 112, Laws of Hong Kong.
[15] Inland Revenue (Disclosure of Information) Rules, Cap 112BI, Laws of Hong Kong.

- Mexico
- Pakistan
- Saudi Arabia
- United Arab Emirates

Table 1 below shows all of Hong Kong's existing DTAs, with the date the DTA was signed, the date it was ratified by the Hong Kong government, the date of its entry into force, and the first Hong Kong tax year of assessment for which the DTA is effective. Older versions of the treaties with Mainland China and Luxembourg are also shown.

Notable for their absence from the existing list of DTAs are several of Hong Kong's largest trading partners, including the United States, Canada, Australia, Germany, Singapore, and Taiwan. There are rumours, however, that some kind of double tax "arrangement" with Taiwan may be in the works.

Table 1: Hong Kong's existing DTAs

Country	Date Signed	Date of Order	Entry into Force	Effective Date
Austria	05.05.2010	28.09.2010	01.01.2011	Y/A 2012/2013
Belgium	10.12.2003	03.02.2004	07.10.2004	Y/A 2004/2005
Brunei	20.03.2010	22.06.2010	19.12.2010	Y/A 2011/2012
Czech Republic	06.06.2011			
France	21.10.2010			
Hungary	12.05.2010	28.09.2010	23.02.2011	Y/A 2012/2013
Indonesia	23.03.2010	22.06.2010		
Ireland	22.06.2010	28.09.2010	10.02.2011	Y/A 2012/2013
Japan	09.11.2010			
Kuwait	13.05.2010			
Liechtenstein	12.08.2010			
Luxembourg	11.11.2010			
Luxembourg	02.11.2007	22.01.2008	20.01.2009	Y/A 2008/2009
Mainland China	27.05.2010			
Mainland China	30.01.2008	15.04.2008	11.06.2008	11.06.2008
Mainland China	21.08.2006	17.10.2006	08.12.2006	Y/A 2007/2008
Mainland China	11.02.1998	24.02.1998	10.04.1998	Y/A 1998/1999
Netherlands	22.03.2010	22.06.2010		
New Zealand	01.12.2010			
Portugal	22.03.2011			
Spain	01.04.2011			
Switzerland	06.12.2010			
Thailand	07.09.2005	18.10.2005	07.12.2005	Y/A 2006/2007
Vietnam	16.12.2008	21.04.2009	12.08.2009	Y/A 2010/2011
United Kingdom	21.06.2010	28.09.2010	20.12.2010	Y/A 2011/2012

4. ISSUES ARISING UNDER THE DTAS

Although Hong Kong continues to have the limited tax system described at the outset of this article, its DTAs contain most of the provisions of the OECD model DTA. In order of importance to Hong Kong, these include:

- Exchange of information on request, regardless of domestic tax interest
- Permanent establishment (PE) provisions
- Reduction of withholding taxes on dividends, interest and royalties
- Provisions relating to individual residents and employment income
- Limitation on benefits provisions
- Allocation of taxing rights on capital gains
- Provisions on transactions between associated enterprises

Issues are already beginning to arise under some of the DTAs. For example, some treaties expressly preserve the right of the parties to apply the anti-avoidance provisions of their domestic tax laws to items of income covered by the treaty.[16] This can cause a problem if, for example, anti-avoidance provisions in domestic law require full withholding tax on deductible payments to a nonresident that is not subject to tax on receipt of the payment under the tax laws of the nonresident's home country. As discussed earlier, Hong Kong profits tax does not apply to income arising outside Hong Kong, under the terms of the Inland Revenue Ordinance. Consequently, Hong Kong-based companies may encounter difficulty in obtaining withholding tax reductions under DTAs with certain countries, Indonesia being one example.

Mainland China has also denied the benefits of the PRC-Hong Kong double tax arrangement to a Hong Kong company in at least one case. The Hong Kong company in question owned 15.6 percent of the shares in a PRC company, and sold some of the shares, realizing substantial gains. The Hong Kong company claimed that it was exempt from taxation in the Mainland under Article 13(5) of the double tax arrangement, which provides a tax exemption for gains on share sales if the recipient of the gains owns less than 25 percent of the company whose shares were sold. The Fujian tax authorities denied the claim on the ground that the "recipient of the gains" was not the Hong Kong company but rather its sole shareholder, an individual who also owned all of the shares of a second Hong Kong company that owned 22.49 percent of the shares of the same PRC company.[17]

Exchange of information will undoubtedly give rise to issues in practice. Under the Inland Revenue (Disclosure of Information) Rules and the stated policy of the Inland Revenue Department in its Departmental Interpretation and Practice Notes No. 47, an information request from a treaty partner must contain certain particulars, in order to prevent so-called "fishing expeditions" by foreign governments. In addition, the person in Hong Kong who is the subject of a disclosure request must be notified and allowed to review the request and ask for amendments. If the Commissioner of Inland Revenue rejects requested amendments, the subject person can ask for review by the

[16] See, eg, Hong Kong-Indonesia DTA, Article 27, available online at www.ird.gov.hk.

[17] See Su Lei, Wei Wenzhong, and Chen Guangping, "A Hong Kong Company Paid Tax on the Disposition of A Shares at the Amount of CNY379 Million," *China Taxation News*, June 30, 2010.

Financial Secretary. It is too early to tell how all of this will play out in practice, but it is reasonable to expect that taxpayers will do all in their power to resist information being provided to requesting foreign government.

Another issue that has arisen as a result of Hong Kong's DTAs is whether arm's length transfer pricing is now required for Hong Kong tax purposes. Hong Kong has no arm's length pricing rule, per se. The Inland Revenue Ordinance contains an untested provision that imputes profits of a nonresident associate to a Hong Kong taxpayer if the business between them results in less profit for the Hong Kong taxpayer than might reasonably be expected.[18] The Ordinance also includes a general anti-avoidance rule that applies when it would be concluded that a transaction was entered into for the sole or dominant purpose of obtaining a tax benefit.[19] In addition, the courts have held that the deductibility of business expenses can be limited to a commercially reasonable amount in cases where the relevant transaction was between the taxpayer and a related person.[20]

DTAs permit each party to impose arm's length pricing on transactions between associated enterprises resident in the two states. A correlative adjustment may be required by a DTA if a pricing adjustment has been made by the other treaty party. However, apart from that circumstance, there is nothing in Hong Kong's DTAs that requires Hong Kong to assess profits tax on the basis of arm's-length pricing. Nevertheless, in December 2009 the Inland Revenue Department asserted the right to use arm's length pricing for HK taxation generally, using Hong Kong's DTAs as one basis for its position.[21] Hong Kong tax professionals are unsure what the state of the law is in this area.

5. CONCLUSION

In the space of just over one year, Hong Kong's tax treaty network expanded from five treaties to twenty-one treaties. The dramatic increase was motivated by fear of countermeasures by G-20 countries against uncooperative jurisdictions in the effective exchange of information, and by Hong Kong's desire to be part of the broader 'international tax community'. Hong Kong's new treaty partners include some major trading partner countries, such as Japan and the U.K., but do not include other major trading partner countries such as the United States and Australia. The treaties will give rise to new issues in Hong Kong taxation, including questions involving the application of anti-avoidance rules, the new regulations on exchange of information, and transfer pricing.

[18] Inland Revenue Ordinance, s 20.

[19] Inland Revenue Ordinance, s 61A. This provision was applied so as to require arm's-length pricing between affiliates in *Ngai Lik Electronics Company Limited v. Commissioner of Inland Revenue*, (FACV No.29 of 2008), Court of Final Appeal, 8 July 2009.

[20] See, eg, So Kai Tong, Stanley v Commissioner of Inland Revenue [2004] 2 HKLRD 416.

[21] See Inland Revenue Department, Departmental Interpretation and Practice Notes No. 46, available online at www.ird.gov.hk.