# News Flash

## Hong Kong Tax

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Our Hong Kong Corporate Tax team provides a full range of integrated professional services in tax consulting and compliance. Our tax specialists provide technically robust, industry specific and pragmatic solutions to our clients on Hong Kong, PRC and international tax issues.

## China issued rules on treaty benefit claims by non-residents – What does it mean for Hong Kong tax resident companies?

On 24 August 2009, the China State Administration of Taxation (“SAT”) issued Guoshuifa [2009] 124 (“Circular 124”) setting out comprehensive measures for administering treaty benefit claims of non-tax resident enterprises and individuals of China on their China-sourced income under a Sino-foreign double tax agreement (“DTA”). Circular 124 took effect on 1 October 2009.

According to Circular 124, non-tax residents of China who wish to enjoy a treaty benefit on their China-sourced income under a DTA have to go through either an “Approval-application” procedure (for passive income -- dividends, interest, royalties and capital gains) or “Record-filing” procedure (for active income -- business profits of a permanent establishment, service fees and personal employment income) in which specific forms attached to Circular 124 have to be submitted to the relevant Chinese tax authorities together with the relevant supporting documentation. For details of the procedures and documentation requirements under Circular 124 and our observations from a China tax perspective, please refer to our China Tax and Business Advisory News Flash, [2009] Issue 20 – *Treaty Residents Having Clearer Rules for Claiming Benefits under Double Tax Agreements*, issued in September 2009.

This News Flash focuses on the implications of Circular 124 for a Hong Kong incorporated company or a non-Hong Kong company with its management or control in Hong Kong (collectively referred to as “Hong Kong tax resident” hereinafter), wishing to claim treaty benefits under the comprehensive DTA between China and Hong Kong (“Mainland-HK DTA”) on their China-sourced income.

### Circular 124

Circular 124 (Annexes 1 and 2) has now made it clear that a treaty resident who wishes to claim treaty benefits under a DTA signed between China and its jurisdiction has to either (1) obtain a certification of their resident status in that other DTA state from the competent authority (usually the tax authority in charge) of that other DTA state on the specific forms attached to Circular 124, or (2) produce a tax resident certificate (“TRC”) issued by such authority in that other DTA state.

In addition, Circular 124 (Annex 3) further imposes a substantial information disclosure requirement for those who wish to enjoy a treaty benefit on their China-sourced passive income under a DTA. Information that needs to be disclosed in applying for an approval of a treaty benefit claim on passive income

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includes: the basic particulars of the applicant in the other DTA state, the tax payment made by the applicant in the other DTA state, certain shareholdings of the applicant, the projects or business carried out by the applicant in the other DTA state, as well as transactions and payments effected by the applicant with certain associated parties of the applicant, etc.

## Application for tax resident certificate in Hong Kong

The procedures for applying a Hong Kong TRC are provided in the Frequently Asked Questions ("FAQs") on Double Taxation Relief issued by the Inland Revenue Department ("IRD"). FAQ 17 specifies that *"… Where the Mainland tax authorities cannot ascertain that the person is a resident of Hong Kong from available information, the Mainland tax authorities (at the provincial (city) level or higher) will issue a referral letter entitled 《關於請香港特別行政區稅務主管當局出具居民証明的函》 to the person concerned for applying a Certificate of Hong Kong Resident Status from the IRD".* FAQ 18 further explains that *"under normal circumstances, the Mainland would accept the Identity Card, Re-entry Permit, Certificate of Incorporation, and certified extract of the Business Registration particulars issued by Hong Kong as evidence in determining the resident status of a Hong Kong resident. Only when the Mainland tax authority is not able to ascertain the resident status would it issue a referral letter to the applicant for obtaining a certificate of resident status from the IRD. This referral arrangement improves work efficiency and ensures that a taxpayer makes an application only where there is a real need for it".* The application form (i.e. Form IR 1313A) is available on the IRD's website.

## PwC observations

### *Procedural issues*

Article 4 of the Mainland-HK DTA provides that "a company incorporated in Hong Kong or if incorporated outside Hong Kong, being normally managed or controlled in Hong Kong", will be considered as a Hong Kong tax resident for the purpose of the DTA. However, some unresolved procedural issues remain for a Hong Kong company or a foreign company with its management or control in Hong Kong to obtain treaty benefits in China under the DTA. These issues include:

- *Whether a Hong Kong incorporated company requires a Hong Kong TRC for the Mainland-HK DTA purposes?* Although the IRD takes the view that according to the Mainland-HK DTA, a Hong Kong incorporated company should not be required to obtain a Hong Kong TRC for the purpose of the DTA, we understand that there are cases where the Chinese local tax bureaus required a Hong Kong incorporated company to produce a Hong Kong TRC even upon production of a certificate of incorporation

- *How to handle the situation where the Chinese local tax bureau does not issue a referral letter to a foreign company with its management or control in Hong Kong?* There are cases where the Chinese local-level tax bureaus were reluctant to issue a referral letter mentioned above (which is required for lodging an application for a Hong Kong TRC to the IRD) to the foreign company which has its management or control in Hong Kong. Without the referral letter, the IRD may not entertain an application for a Hong Kong TRC.

- *Can a Hong Kong company or a foreign company with its management or control in Hong Kong ask the IRD to endorse on the specific forms attached to Circular 124?* Circular 124 allows taxpayers of other DTA states to obtain an endorsement of their resident status from the competent authority of the other DTA states on the specific forms attached to Circular 124. According to the Mainland-HK DTA, the certificate of incorporation of a Hong Kong incorporated company should be good enough for substantiating the Hong Kong tax resident identity. It should be unnecessary for them to get the IRD's endorsement. For a foreign company with its management or control in Hong Kong, it is yet uncertain whether the IRD will, upon request, fill in and endorse the resident certification section of those specific forms for submission to the Chinese tax authorities for approval-application or record-filing purposes as per Circular 124 requirement.

- *How to deal with the situation where a Hong Kong tax resident derives income from different locations in China?* When a Hong Kong tax resident receives passive income from different locations in China, it may be required by the local-level tax bureau in each of the respective regions to file separate treaty benefit application with a copy

of a Hong Kong TRC. This means the Hong Kong tax resident may need several copies of Hong Kong TRC whereas the IRD will only issue one.

We are expecting that the IRD and the SAT will work together to resolve the above issues soon and simplify the administrative procedures for all the parties involved.

### *Possible exchange of information*

The recent proposed amendments to the Inland Revenue Ordinance[1] reveal that Hong Kong will, following the international trend, adopt the more liberal version of Exchange of Information ("EoI") article in her DTA negotiations or re-negotiations of existing DTAs. Under this version of EoI article, information concerning taxation matters of the other jurisdiction related to taxes covered by the EoI article will be exchanged. It is likely that the SAT and the IRD will adopt this version of EoI article in their future DTA re-negotiation. The possible exchange of information between the SAT and the IRD makes it important that the information disclosed in the approval-application or record-filing processes under Circular 124 should be consistent with the information filed with the IRD.

### *Substance over form*

Compared to the procedural issues highlighted above, a more significant implication of Circular 124 for Hong Kong companies (or foreign companies considering themselves as a Hong Kong tax resident) is the increased scrutiny and the extensive information disclosure requirements imposed by Circular 124. The requirements in Circular 124 suggest that the Chinese tax authorities are ready to look beyond a TRC or a certificate of incorporation and examine the other relevant factors in assessing whether the companies really qualify as a Hong Kong tax resident as well as whether they are genuinely entitled to the treaty benefits claimed.

As hinted in the approval-application / record-filing forms attached to Circular 124, one of the factors to be considered by the Chinese tax authorities is whether there is any "substance" of the Hong Kong tax resident. For example, if a Hong Kong intermediate holding company is being interposed between the non-Hong Kong ultimate holding company and an investee company in China to enjoy the reduced Chinese withholding tax rate on dividends under the Mainland-HK DTA, the Hong Kong intermediate company should be able to demonstrate, among other things, that it genuinely functions as an investment holding company and that its key investment management activities are being carried out in Hong Kong. A company that is merely incorporated in Hong Kong without much substance in Hong Kong would find it difficult to withstand any challenges from the Chinese tax authorities of its Hong Kong tax residency, even if it was able to produce the certificate of incorporation or even obtain a Hong Kong TRC from the IRD.

### *Beneficial ownership*

The concept of "beneficial ownership" is embedded in the Dividends Article of the Mainland-HK DTA (similarly in the Royalties and Interest Articles) and that the reduced withholding rate is only applicable if "the beneficial owner" of the Chinese-sourced dividends is a resident of the other DTA state. It is not uncommon for multinational companies (non-Hong Kong residents) to use a Hong Kong intermediate holding company to hold their equity investments in China for commercial reasons. Dividends paid by these Chinese companies to the Hong Kong intermediate holding company may be onward distributed to its non-Hong Kong resident ultimate parent in another jurisdiction. Under this situation, one of the possible interpretations is that the non-Hong Kong resident ultimate parent, instead of the Hong Kong intermediate holding company, is the "beneficial owner" of the dividends, and as a result, the preferential (restricted) treaty rate in the Mainland-HK DTA is not applicable.

In the above situation, if the non-Hong Kong resident ultimate parent in another jurisdiction (for example Japan) which has a DTA with China is considered to be the "beneficial owner" of the dividends, it is not yet certain whether the SAT would consider granting the treaty benefits under that DTA (China-Japan treaty in the example).

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[1] Please refer to our Hong Kong Tax News Flash, [2009] Issue 7 – *A step towards liberalising the exchange of tax information in Hong Kong: The Inland Revenue (Amendment) (No.3) Bill 2009,* issued in July 2009.

### *Treaty shopping and general anti-avoidance provision*

One may question the basis upon which the Chinese tax authorities look beyond the TRC issued by the IRD and seek for substance and beneficial ownership, etc. However, it should be noted that under Article 25 (Miscellaneous Provisions) of the Mainland-HK DTA, both Hong Kong and China have the right to apply their domestic anti-avoidance rules and measures where appropriate despite the provisions in the Mainland-HK DTA.

In the China Corporate Income Tax Law and its detailed implementation regulations that became effective on 1 January 2008, there is a specific chapter titled "Special Tax Adjustments" which contains the so-called General Anti-avoidance Rules ("GAAR"). In particular, the GAAR allow the Chinese tax authorities to make special tax adjustment using appropriate methods where an arrangement is entered into by an enterprise without "reasonable commercial reason" and which results in a reduction, exemption or deferral of Chinese tax payments. These GAAR under the Chinese domestic law are powerful tools for the Chinese tax authorities to tackle treaty shopping or abusive use of treaty.

### *Concluding remark*

The approval-application and record-filing processes stipulated in Circular 124 require Hong Kong tax residents that wish to enjoy the treaty benefits under the Mainland-HK DTA to provide more disclosure than simply producing a certificate of incorporation or a Hong Kong TRC. The disclosure required by Circular 124 indicates the Chinese tax authorities' stepping up of their efforts in combating abusive use of treat benefits in order to protect the China tax revenue base, and non-tax residents of China deriving China-sourced income are definitely on their radar screen.

Circular 124 thus makes it clear that Hong Kong incorporated companies (or foreign companies considering themselves as a Hong Kong tax resident) cannot take it for granted that they can enjoy the treaty benefits under the Mainland-HK DTA for their incomes from China. The procedures in Circular 124 can be considered as the safeguards in ensuring Hong Kong tax residents have substance and are beneficial owners for enjoying the treaty benefits under the Mainland-HK DTA. Complying with the procedural requirements in Circular 124 is only a minimum requirement for Hong Kong tax residents to enjoy or continue to enjoy the treaty benefits under the Mainland-HK DTA. In the long run, if Hong Kong tax residents wish to continue to make use of the Mainland-HK DTA for investing into China, they should review their current holding and/or operating structure in Hong Kong to ensure there are reasonable commercial purposes and adequate business justification in the structure with proper documentation such that the substance and non-tax driven purposes can be substantiated.

In the context of this News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

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