

IRD's adjusted approach to the issuance of Certificate of Resident Status: Only residence matters

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In brief

The Inland Revenue Department (IRD) has recently revisited its approach to the issuance of Hong Kong Certificate of Resident Status (HK CoR) and announced that effective from 12 June 2023, it will base its decision of whether an HK CoR can be issued on the plain definition of 'resident of Hong Kong' in the relevant comprehensive avoidance of double taxation agreement/arrangement (CDTA). The application forms have also been revised to reflect its latest approach¹.

As an entity incorporated or constituted under the laws of Hong Kong would by definition qualify as a Hong Kong tax resident in most CDTAs signed by Hong Kong, such an entity is now only required to provide basic information about its business particulars in the revised application forms.

An exception to the above is in respect of applications in relation to tax benefits claim under the CDTA between Hong Kong and Japan, which defines 'resident of Hong Kong' as an entity having a primary place of management and control in Hong Kong. As such, an applicant that is a Hong Kong incorporated/constituted entity is still required to provide detailed information about its establishment and business substance in and outside Hong Kong.

Where an application for an HK CoR is in relation to tax benefits claim on dividends that falls within the relevant provisions of the *Circular of the State Taxation Administration on Matters Concerning 'Beneficial Owners' in Tax Treaties (STA Circular 2018 No. 9) (PN 9)*, the applicant is also required to provide particulars of the lead applicant in the multi-level holding structure and other relevant information.

This news flash summarises the salient features of the revised application forms applicable to non-individuals² and our observations on the implications of the IRD's adjusted approach for tax benefit claimants under Hong Kong's CDTAs.

Taxpayers should also bear in mind that being able to obtain an HK CoR is only the first step in claiming tax benefits under a CDTA. A Hong Kong tax resident without economic substance in Hong Kong or failing to meet the other conditions in the CDTA could still be denied treaty benefits by the treaty partner.

In detail

IRD's previous approach to the issuance of HK CoR

Except for the CDTA between Hong Kong and Japan which adopts a more stringent definition of 'resident of Hong Kong' for non-individuals³, an entity that is incorporated or constituted under the laws of Hong Kong would by definition qualify as a Hong Kong tax resident in other CDTAs signed by Hong Kong. Where an entity

is not so incorporated or constituted, it would nonetheless generally qualify as a Hong Kong tax resident if it is 'normally managed or controlled in Hong Kong' in most cases⁴.

While an HK CoR should only certify the tax residence of the applicant concerned, the IRD previously indicated that to uphold the terms and purpose of Hong Kong's CDTAs, it had to consider whether the applicant satisfied any additional conditions specified by the relevant articles of a CDTA governing the tax treaty benefits claimed. These additional conditions include requiring the applicant to be the beneficial owner of the income where passive income was concerned and that the arrangement in question was not abusing the terms of a CDTA.

As a result, most Hong Kong incorporated/constituted entities were then required to provide detailed information about their business substance in and outside Hong Kong (e.g. where their board meetings were held, and how and where the strategic policies and key decisions of the business of the applicant were made) when completing the relevant application form⁵.

It is understood that the IRD had on several occasions refused to issue an HK CoR to applicants that met the definition of tax resident under the relevant CDTA on the grounds that they had insufficient economic substance in Hong Kong. Such an approach has been challenged by certain applicants, which might have triggered the IRD to review and adjust its mechanism for processing an HK CoR application.

Under the IRD's adjusted approach, when processing an HK CoR application, it will only consider whether an applicant meets the plain definition of 'resident of Hong Kong' under the CDTA concerned. The application forms have also been revised to reflect the change in its approach.

Salient features of the revised application forms

- Same as the previous application process, an entity applying for an HK CoR under the CDTA between Mainland China and Hong Kong is required to complete Form IR1313A. For an application made under other CDTAs concluded by Hong Kong, an entity is required to complete Form IR1313B. Except for a few additional pieces of information required in Form IR1313A, the two forms are essentially identical.
- The revised application forms only require an entity that is incorporated/constituted in Hong Kong to state certain basic information and particulars concerning itself, details (including the beneficial owner) of the income in respect of which tax benefits are claimed, as well as the number of directors/partners/trustees, senior management personnel and other staff with fixed place of residence in and outside Hong Kong.
- In addition to basic information, an entity that (i) is incorporated/constituted under foreign laws; or (ii) wishes to claim treaty benefits under the CDTA between Hong Kong and Japan (regardless of its place of incorporation/constitution), is also required to complete Part 1 of the Appendix to Form IR1313A or the Appendix to Form IR1313B, which requires the applicant to provide detailed information about its business activities in Hong Kong so as to demonstrate its normal management and/or control or central management and control (as the case may be) was exercised in Hong Kong. The information required is broadly the same as that in the old forms.
- Where an application for an HK CoR is in relation to tax benefits claim on dividends falling within Article 3 (i.e. the same jurisdiction rule or same treaty benefit rule) or Article 4 (i.e. the safe harbour rule) of PN 9, the applicant is required to complete Part 2 of the Appendix to Form IR1313A to state the applicable provision of PN 9 and particulars of the lead applicant in the multi-level holding structure.
- The lead applicant and each of the co-applicants should fill in its own application form and submit their applications in a bundle. Any applicant (not being an individual) can be designated as the lead applicant and serve as the primary point of contact on behalf of all the applicants.
- The lead applicant is also required to complete item 14 of the Appendix to Form IR1313A and provide the information specified therein, which includes (i) an organisation chart showing the relevant multi-level holding structure; (ii) the particulars for each person in the chart other than the lead applicant and co-applicants; and (iii) details of any change in equity interest of any person in the chart during the 12 consecutive months before dividends were/are to be received.

The administrative arrangement agreed between the tax authorities of Mainland China and Hong Kong that an HK CoR will serve as a proof of the Hong Kong resident status of an applicant for the calendar year and the two succeeding calendar years will remain unchanged.

Our observations: *We welcome the IRD's formalising the existing administrative facilitation measures with respect to applications for HK CoR in relation to PN 9. Equally welcoming is the IRD's adjusted approach to the issuance of HK CoR based on tax residence alone. This would likely simplify the process of applying for an HK CoR for an entity incorporated/constituted in Hong Kong. The adjusted approach should also put to rest any doubts about the appropriateness of the IRD's consideration of other matters in addition to residence, as the relevant terms 'incorporated in Hong Kong' and 'constituted under the laws of Hong Kong' contained in most CDTAs signed by Hong Kong are strict definitional provisions with no apparent qualification.*

The takeaway

Taxpayers are reminded that being a resident of Hong Kong is only one of the qualifying conditions for claiming tax benefits under a CDTA. Typically, the relevant articles governing the tax benefits offered under a CDTA in respect of passive income require the recipient to be the beneficial owner of the income concerned, as opposed to being an agent or a nominee, or a mere conduit company.

Furthermore, the majority of the CDTAs signed by Hong Kong contain the principal purpose test rule, which seeks to deny treaty benefits in cases where one of the principal purposes of the arrangements or transactions is to secure a benefit under the treaty in a manner that is contrary to the object and purpose of the treaty. Ultimately, the decision as to whether a treaty benefit is granted is one to be made by the treaty partner.

As such, it is plausible that the treaty partner may request the IRD to provide further information via exchange of information to verify the applicant's entitlement to the tax benefits sought, either as part of the process of granting the benefits or in a post-filing audit or random check. The process of claiming tax treaty benefits may not be plain sailing in certain circumstances.

In light of the above, taxpayers are advised to review their current cross-border arrangements and assess the robustness of their tax treaty benefits claims before filing an application for an HK CoR as it may be difficult for them to defend their case if and when challenged by the tax authorities of the treaty partner.

On a separate but related matter, economic substance has become increasingly important in today's environment, particularly given the refined foreign-sourced income exemption (FSIE) regime⁶ which became effective on 1 January 2023, with further changes to the regime expected to be made this year. It is worth noting that in situations where a covered taxpayer under the FSIE regime is able to obtain tax exemption in the foreign jurisdiction under the relevant CDTA in respect of its foreign-sourced disposal gain on the sale of equity interests, it will not be able to claim non-taxable treatment in Hong Kong by relying on the participation requirement as it will not be able to meet the 'subject to tax' condition within the requirement, and consequently must meet the economic substance requirement in order to qualify for non-taxable claim.

In view of the everchanging tax rules and practices and the complex interactions between different rules, we recommend that taxpayers seek professional advice as necessary.

Endnotes

1. The press release and the revised application forms can be accessed via the following links:
<https://www.ird.gov.hk/eng/ppr/archives/23060801.htm>
https://www.ird.gov.hk/eng/tax/dta_cor.htm#form
2. The application forms for individuals remain broadly the same with only minor changes to the notes.
3. 'Resident of Hong Kong' is defined in the CDTA between Hong Kong and Japan, as far as non-individuals are concerned, to mean a company or any other person having a primary place of management and control in Hong Kong, and the term 'a primary place of management and control' is further defined to mean a place where executive officers and senior management employees of a company or

any other person make day-to-day key decisions for the strategic, financial and operational policies for the company or the person, and the staff of such company or person conduct the day-to-day activities necessary for making those decisions.

4. A majority of the CDTAs signed by Hong Kong adopt the 'normally managed or controlled in Hong Kong' residence test. Most of the remaining CDTAs either apply the 'centrally managed and controlled in Hong Kong' or 'normally managed and control in Hong Kong' test.
5. Entities incorporated/constituted in Hong Kong were exempted from providing such information if they satisfy any one of the following three conditions: (i) they had more than two members; (ii) they were statutory corporations; or (iii) they were part of a listed group during the year concerned.
6. Please visit our designated FSIE webpage via the following link for further details:
<https://www.pwccn.com/en/services/tax/fsie.htm>

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