香港會計師公會
HONG KONG SOCIETY OF ACCOUNTANTS
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**BY FAX AND BY POST**
**(2877 1082)**

Our Ref.: C/TXM, M23512 19 November 2003

Mrs. Alice Lau Mak Yee-ming,
Commissioner of Inland Revenue,
Inland Revenue Department,
36/F, Revenue Tower,
5 Gloucester Road,
Wanchai, Hong Kong.

Dear Mrs. Lau,

**Proposed Double Tax Agreements – Hong Kong**

I am writing to convey the views of the Taxation Committee of the Hong Kong Society of Accountants on the issue of Double Tax Agreements ("DTAs") between Hong Kong and other jurisdictions. We understand that the Government is taking positive steps to negotiate DTAs with jurisdictions such as Belgium, and believe that in the course of such negotiations, the special circumstances of Hong Kong's territorial taxation system should be taken into account to the extent possible.

It is, of course, fundamental in drafting a DTA that it should be absolutely clear as to the persons, including companies, to which it applies. This is typically done through the introduction of "residence" concepts. In most jurisdictions, this works well because tax is imposed on the basis of residence, and it is only persons subject to tax in the particular jurisdiction which should, or indeed need to, benefit from the DTA.

Hong Kong, however, is somewhat different in that tax is not imposed on the basis of domicile, incorporation or management and control. Moreover, for various reasons, a much higher proportion of Hong Kong businesses are actually organised as branches of foreign companies than is the case in other jurisdictions. These factors give rise to problems in entering into DTAs based on the OECD model, for reasons explained below.

Firstly, under the OECD model DTAs, the benefits are available to residents of one of the contracting parties. For this purpose, residence is normally defined as meaning a person who is subject to tax in the relevant jurisdiction by reason of their residence, domicile, place of effective management or other similar criterion, in accordance with the laws of that jurisdiction.

Unfortunately, a definition along these lines is not appropriate for Hong Kong as tax is not levied in Hong Kong with regard to such criteria; rather, profits tax is levied where a business is carried on in Hong Kong and derives Hong Kong source profits from that business, but this may also be considered an unacceptable basis for defining a Hong Kong resident as it would encompass persons which were clearly still non-resident under both international principles as well as relevant case law. Our preliminary view is that for the purpose of any DTAs, a Hong Kong resident needs to be defined without reference to liability to Hong Kong tax, but in the case of a company, solely by reference to its


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place of effective central management and control, and for an individual, in a manner that reflects the common law meaning of the term.

For completeness, we note that the normal OECD definition of "resident" is used in the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income ("the Arrangement"). Whilst this appears to have presented few practical problems, we believe that this is due to the special relationship between Hong Kong and the Mainland, the pragmatic approach adopted by the respective tax administrations and the limited scope of the Arrangement. We do not believe that the administration of a more comprehensive DTA with a third country would be as smooth if this important definitional issue is not properly addressed.

Adopting a definition as proposed above would address the second issue of the position of Hong Kong businesses that are organised as branches of non-Hong Kong companies. This is because offshore companies established to conduct business solely or predominantly in Hong Kong would likely qualify as residents of Hong Kong even though they may be incorporated elsewhere. The following two examples illustrate this point; in both cases, we believe the benefits of any DTA should be available to the companies in question, although it is questionable whether they would be under a definition of the type used in the OECD model DTA.

1. A company which is incorporated overseas, in the Cayman Islands for example, but which is listed solely in Hong Kong, and has a branch registration in Hong Kong, but no other activities. Would that company by virtue of those facts be able to take advantage of the DTA? It may or may not be a profits-tax-paying company in Hong Kong, depending on the nature and location of its income. Most, however, would regard it as a Hong Kong company.

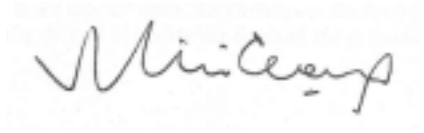
2. A Hong Kong-incorporated company may have successfully achieved an offshore taxation claim, which is often an "all or nothing" claim. Assume its activities are trading activities and its income is substantial; it may have an office in Hong Kong but it may not be subject to Hong Kong profits tax, as the profits are earned outside Hong Kong. In those circumstances, will the DTA apply to any payments made or received by the Hong Kong company? This is a significant question, as substantial numbers of Hong Kong subsidiaries will have a trading business in Hong Kong where the majority of the profits will be tax free in Hong Kong.

We trust that consideration of the impact of the DTA on these cases will be of some assistance in the practicalities of negotiations with other governments regarding the DTA.

We believe that these issues should also be taken into account in future negotiations concerning revisions to the Arrangement, and in the context of CEPA, as similar issues arise and should be dealt with consistently, so as not to cause unnecessary complications in structuring or conducting a business in Hong Kong.

Finally we would like to express the view that if the Hong Kong Government is going to permit exchange of information provisions within any DTA, as a quid pro quo the other government involved should be persuaded to reduce withholding taxes on payments of dividends, interest and royalties to Hong Kong.

Yours sincerely,



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