

Agenda item A3 - Cross-border tax issues

(a) Discussion with State Administration of Taxation ("SAT")

Questions regarding double taxation of income in Hong Kong and Mainland China (e.g., bonus income) were raised in previous annual meetings (2007 agenda item A2(b); 2009 agenda item A4(d); and 2010 agenda item A4(d)(ii)). The IRD indicated that, where sufficient data on actual cases is available, it would consider raising the issue in its annual meeting with the SAT. In this connection, the Institute would like to ask if the IRD could give an update on the discussions with the SAT.

CIR advised that the IRD had already raised this issue with the SAT during the annual meeting in November 2010. The SAT was fully aware of the cases of double taxation of bonus income and was considering possible measures to rectify the situation.

Agenda item A4 - Double tax agreements

(a) Application of treaty provisions and domestic anti-tax avoidance rules by treaty partners

Hong Kong has recently signed comprehensive double tax agreement/ arrangement ("CDTA") with numerous countries that provide for reduced withholding tax rates on passive incomes and/ or tax exemption on capital gains from disposal of shares in certain circumstances. However, most of these CDTA's also include, in the dividends/ interest/ royalties articles, a provision that requires the recipient of such incomes to be the beneficial owner of the incomes and a limitation of benefits clause that denies the benefits of the relevant article if the main purpose of any person concerned was to take advantage of that article. In addition, contracting parties may also apply their domestic laws and measures concerning tax avoidance to deny treaty benefit.

As a result, the contracting parties' interpretation of "beneficial owner" and application of their domestic anti-treaty shopping rules would affect whether Hong Kong residents are eligible for the treaty benefits under a given CDTA. For example, Mainland China has set out its rules on assessing beneficial ownership for the purpose of claiming a treaty benefit under the passive income articles in Guoshuihan [2009] No. 601 and Indonesia has issued a series of anti-treaty abuse regulations that impose various requirements (e.g. a requirement for the claimant to have substance) for enjoying a treaty benefit under an Indonesian treaty.

In this regard, the Institute would like to know the following:

- (i) While the Institute understand there may be differences in the interpretation of these anti-treaty shopping rules, the Institute would like to seek clarification from the IRD on its interpretation of "beneficial ownership".

CIR advised that whilst Hong Kong was a common law jurisdiction and the term “beneficial ownership” had a narrow technical meaning in the domestic law, many of Hong Kong’s treaty partners would interpret the term in the context of a tax treaty the object and purposes of which included the avoidance of double taxation and the prevention of fiscal evasion. Generally, the “beneficial ownership” limitation would exclude: mere nominees or agents who were not owners of the income; and conduits who, though formal owners of the income, had very narrow powers over the income or did not have the full privilege directly to benefit from the income which rendered the conduits a mere fiduciary or administrator of the income. CIR referred members to the Commentaries on Article 1 of the OECD Model Tax Convention (July 2010 edition).

CIR added that apart from those positions which Hong Kong had stated in the Model Tax Convention, Hong Kong would generally follow OECD’s Commentaries and interpretation elaborated in the Model Tax Convention.

- (ii) Whether the IRD has any plan to seek the views of the existing contracting parties on their application of the domestic anti-avoidance/ anti-treaty shopping rules in order to provide greater certainty to Hong Kong taxpayers; and whether the IRD would address this issue in future CDTA negotiations.

CIR advised that the IRD would seek the views of existing CDTA partners on the application of domestic anti-avoidance/anti-treaty shopping rules as and when the circumstances warranted.

CIR remarked that each treaty had, as one of its main purposes, the prevention of fiscal evasion, and jurisdictions were more than ever adamant to avoid any double non-taxation brought about or facilitated by the treaties in a bid to protect the tax dollars. There were also sovereign issues sometimes. So the IRD would endeavour to clarify the domestic anti-avoidance/anti-treaty shopping rules in its future CDTA negotiations (the IRD had been doing this for some time in recent negotiations), but there were obvious limitations in what could be done in this respect.

Mr Tam noted that, for a special purpose vehicle established by a Hong Kong company for investments held in the Mainland, the Mainland seemed to have adopted a narrow view in the interpretation of “beneficial ownership” which operated to deny the treaty benefits under the CDTA. CIR said that the SAT had to act cautiously to avoid abuses. However, they were aware of the problem and were reconsidering the issue.

(b) Attributing profits to a permanent establishment in Hong Kong of a non-resident

In determining the source of a profit for Hong Kong profits tax purpose, the broad guiding principle is to see what the enterprise has done to earn the profits in question and where the profit-producing operations have been performed. The IRD has also laid down specific sourcing rules for different types of income in revised DIPN 21. For example, apportionment is possible for service fee income (paragraph 46 of DIPN 21) and trading profit is totally sourced in Hong Kong if either the contract of purchase or contract of sale is effected in Hong Kong (point (c), paragraph 23 of DIPN 21).

If a foreign person has a permanent establishment (“PE”) in Hong Kong but its financial statements do not disclose the true profits arising in Hong Kong, Inland Revenue Rule 5 (“IRR 5”) sets out a general method of determining the Hong Kong sourced profits of such PE by applying the worldwide profit margin to the Hong Kong turnover (worldwide profit margin method).

When the foreign person is a tax resident of a jurisdiction with which Hong Kong has a CDTA, the position taken in DIPN 46 is to consider the general principle adopted by the OECD for attribution of profits to a PE/ transfer pricing purpose, that is to look at primarily the risks and functions taken by the enterprise/ PE in question. Paragraph 32 of DIPN 46 further elaborates that *“when assessing the profits of the permanent establishment of a non-resident enterprise, the Commissioner will examine the separate sources of profit that the non-resident enterprise has derived from Hong Kong”*

In this regard, the Institute would like to seek clarifications of the interaction between the Hong Kong source rule and the OECD profit attribution rule in the following situations:

- (i) When the profit of an entity in a CDTA contracting state is derived partly through its PE in Hong Kong (for example service fee income), the profits attributable to the PE should be determined according to the OECD profits attribution rules. What is the IRD’s view on this?

Mr Wong advised that where a person had a PE in Hong Kong, the profit of that PE would be assessed in accordance with Rule 5(2) of the Inland Revenue Rules ("IRR"). According to Rule 5(2)(a) of the IRR, where the person kept accounts for his PE in Hong Kong in such a way that his true profits arising in or derived from Hong Kong could be readily ascertained from those accounts, his assessment to profits tax would be computed by reference to the profits disclosed in those accounts. Rules 5(2)(b) and (c) of the IRR further provided that where the person's accounts did not disclose the true profits arising in or derived from Hong Kong, his tax liability would be computed by reference to his total profits wherever made after necessary adjustments in accordance with the IRO. Where it was impracticable or inequitable to do so, Rule 5(2)(d) provided for the computation of profit on a fair percentage of the turnover of the person in Hong Kong.

Mr Wong explained that Article 7(2) of the OECD Model Tax Convention on Income and on Capital ("the OECD Model") stated that the profits that were attributable to the PE in each contracting state were the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, as if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise.

Mr Wong further explained that in principle, the PE in Hong Kong should make up its accounts and report the profits according to the arm's length principle endorsed by the OECD Model. Thus if a profit of the PE as shown in its accounts was derived from Hong Kong, the profit would be fully charged to profits tax and would not be reduced unless there was an upward profit reallocation adjustment by the tax administration of the other CDTA jurisdiction with which the Commissioner agreed both in principle and in amount. The obligation to provide relief was contained in the Methods for Elimination of Double Taxation Article [see paragraph 38 of DIPN 45].

- (ii) A foreign stockbroker with head office located in a country having a CDTA with Hong Kong (e.g. Japan) has a branch in Hong Kong. The Hong Kong branch is responsible for performing marketing activities, taking orders from Hong Kong customers and managing the Hong Kong customer accounts, whereas the head office in the foreign country will execute transactions at the stock exchange in that foreign country based on customer orders received from the Hong Kong branch. Based on the principle laid down in the *ING Baring* case, the entire stock brokerage commission profits derived by the foreign head office will be of a non-Hong Kong source as the stock transactions are executed overseas. However, based on the OECD profit attribution rule, certain amount of commission profits should have been attributed to the Hong Kong branch based on the functions performed by it. In this example, will the IRD accept even if there are profits attributable to the PE in Hong Kong, such profits do not have a Hong Kong source?

Mr Wong advised that in the *ING Baring* case, the Court emphasized the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters. The source of those profits must be attributed to the operations of the company which produced them and not to the operations of other members of the group.

Mr Wong explained that if the head office of a non-resident enterprise earned profits with assistance of a PE in Hong Kong and the profits attributable to that head office were accepted by the IRD as offshore in nature, those profits would not be taxable. On the other hand, if the profits attributable to that PE in Hong Kong (e.g. as a service provider) arose in or were derived from Hong Kong, such profits should be taxable. The locality of profits of the head office and that of the profits of the PE in Hong Kong should be separately considered and could not be mixed up.

- (iii) A foreign stockbroker with the head office located in a country having a CDTA with Hong Kong (e.g. Japan) has a branch in Hong Kong. The Hong Kong branch is responsible for buying/ selling Hong Kong listed securities but supporting functions are performed by the head office. Based on the OECD profit attribution rule, the commission profits that would have to be attributed to the Hong Kong branch should be based on the functions performed by it. In this example, will the IRD accept only the portion of commission profits attributable to the PE in Hong Kong and with a Hong Kong source, as determined according to DIPN 46, instead of the entire commission profits, is subject to profits tax in Hong Kong?

Mr Wong advised that there had been no change in the principle used to ascertain the source of a profit. The broad guiding principle was to see what the enterprise has done to earn the profits in question and where the operations have been performed. As mentioned above, if the profit of the Hong Kong branch was derived from Hong Kong, the profit would be fully charged to profits tax and would not be reduced unless the Commissioner was obligated to make a profit reallocation adjustment under the relevant CDTA. In other words, the full amount of profit reported in the accounts of the Hong Kong branch as stated in the question would be subject to profits tax in Hong Kong without reduction.

Ms Macpherson asked, whether there was inconsistent interpretation in the ascertainment of profit accrued to a PE in Hong Kong between the profit attribution rule where profit should be based on a functional analysis and that of the determination of profit per branch's accounts. Mr Wong explained that there should be no inconsistency because the profit attribution rule should have been adopted in the preparation of the branch accounts.

(c) Hong Kong company claiming tax credit under a CDTA

Under Article 22 of the Hong Kong CDTAs:

“Subject to the provisions of the laws of ... Hong Kong ...tax paid in (the other jurisdiction) in accordance with the provisions of this Agreement...in respect of income derived ...from sources in (the other jurisdiction) ...shall be allowed as a credit against Hong Kong tax payable in respect of that income...”

It is noted that the above article is largely in line with the OECD model, except that the words “from sources” are added in the Hong Kong CDTAs. Where it refers to the same “source” concept in our domestic law, questions arise as to whether taxpayers could seek to claim a tax credit to eliminate double taxation given that Hong Kong does not impose tax on non-Hong Kong sourced profits. In this regard, the Institute would like to seek the IRD’s guidance on the meaning of “sources” for the purposes of CDTA.

CIR advised that the words “sources in [a Contracting Party]” referred to sources of income which were derived from the Contracting Party, e.g. the profits of a PE of a Hong Kong company established in that Party (which is sometimes referred to as the “source state”). It was different from the “source” concept under the territorial taxation system adopted by Hong Kong.

CIR further said, in fact, Hong Kong followed the “Elimination of Double Taxation” article (Credit Method) in the OECD Model Tax Convention (Article 23B). The use of the different language, viz. the addition of the words “from sources”, would not affect the tax treatment in substance.

CIR explained that if a source of income from a Contracting Party was not subject to Hong Kong tax because its locality was outside Hong Kong, then of course no question of credit would arise in respect of the tax paid in that jurisdiction on that income. However, there would still be circumstances where a Hong Kong resident would be taxed in Hong Kong in respect of an income derived from and taxed in another jurisdiction.

CIR quoted an example that, Company H was a company incorporated and carried on trading business in Hong Kong. It sold goods to Country A through a representative office established therein. The profit attributable to this office would be regarded as sourced in Country A and subject to tax in Country A. On the other hand, the entire trading profit of Company H would most likely be subject to profits tax in Hong Kong based on the operations test. If there was a CDTA between Hong Kong and Country A, this representative office would be regarded as a PE in Country A and Company H would be able to claim tax credit in Hong Kong in respect of the tax paid on the same income in Country A.

(d) Certificate of Hong Kong resident status for use in CDTA countries other than Mainland China

The Institute understands different CDTA countries may have different practices for Hong Kong residents to claim tax benefits. At present, the forms available for corporate and individual taxpayers to apply for a certificate of Hong Kong resident status ("certificate") (i.e. Forms 1313A and 1314A) are specifically for applications made under the CDTA between Mainland China and Hong Kong. Given that the treaty network of Hong Kong is expanding and more CDTAs will become effective in future, it is likely that there would be more applications for a certificate made under CDTAs other than the one with Mainland China.

In this regard, the Institute would like to ask the following:

- (i) Whether the IRD can obtain clarification from other CDTA contracting countries as to their operational requirements for accepting Hong Kong tax resident status for obtaining treaty benefits.

CIR advised that for the purpose of implementing the CDTAs entered into by Hong Kong, the IRD would liaise with the CDTA partners on details of the administrative procedures shortly before or after the agreements came into operation. These procedures would include certification of residency, which would vary from country to country.

- (ii) If it is necessary to have a certificate, whether the IRD will issue more generic forms for corporate and individual taxpayers to apply for a certificate under all CDTAs. If such generic forms are not made available, by what means can a taxpayer apply for a certificate under CDTAs other than the CDTA with Mainland China.

CIR advised that as more and more CDTAs were negotiated and concluded by Hong Kong, there were bound to be differences in the terms and conditions in the agreements concerning residency. For example, in the Hong Kong/Japan agreement, a company was a Hong Kong resident if it had "a primary place of management and control" (which was defined in the Protocol) in Hong Kong, while in the Hong Kong/UK agreement, a company incorporated outside Hong Kong was a Hong Kong resident if it was "centrally managed and controlled" in Hong Kong. On the other hand, in most of the agreements, a company incorporated outside Hong Kong was a Hong Kong resident if it was "normally managed or controlled" in Hong Kong. Therefore, it was not possible to have a generic application form that fitted all. The IRD's plan was to provide, shortly before or after the relevant agreement came in force, specific forms for specific agreements for the taxpayers' use. In the meantime, a taxpayer could make an application in writing to the Tax Treaty Section of the IRD giving full information on how it had fulfilled the requisite criteria for Hong Kong residency under the particular CDTA in question.

[Post meeting note: The IRD announced on 13 July 2011 that with immediate effect, any application for a certificate of Hong Kong resident status under a comprehensive agreement for the avoidance of double taxation signed between Hong Kong and other jurisdictions (apart from the Mainland of China) has to be made on the standard form IR1313B (for a company, partnership, trust or other body of persons) or IR1314B (for individuals). The applicant is only required to provide basic and general information in the first place. After processing the application, the IRD might request further specific information if considered necessary.]

- (iii) Generally, the jurisdictions with which Hong Kong has a CDTA would require taxpayers to furnish a certificate for claiming a treaty benefit. However, in some cases, the treaty country would require the taxpayer to (i) ask the IRD to put a stamp on a prescribed form; and/or (ii) ask the IRD to issue a letter confirming that the relevant Hong Kong entity has reported and paid taxes in Hong Kong. In this event, the Institute would like to ask if, normally, the IRD would accede to requests of this nature.

CIR advised that as explained in the reply to (i) above, the IRD would discuss the implementing arrangements with the CDTA partners. Depending on the outcomes of the discussion, the IRD would be in a position to stamp on any prescribed forms and/or issue the required confirmation letters to facilitate Hong Kong residents.

(e) Claiming tax deduction or tax credit for foreign withholding tax

As stated in DIPN 28, foreign withholding tax that is charged on the gross amount of income (e.g. interest or royalties) and incurred in the production of profits chargeable to Hong Kong profits tax would be allowed as a deduction under section 16(1). On the other hand, when there is a CDTA between Hong Kong and the jurisdiction from which such income is derived and withholding tax is levied, the CDTA would provide for a relief of double taxation for Hong Kong residents by means of a tax credit against the profits tax payable on such income.

Further, paragraph 6 of revised DIPN 44 on the CDTA between Mainland China and Hong Kong states that Hong Kong adopts the “preferential treatment” principle, i.e. where the comprehensive arrangement and the IRO contain different provisions relating to the same matter, preference will be given to the provisions that are most beneficial to taxpayers.

In the case where a CDTA exists, the Institute would like to seek clarification from the IRD on whether the above “preferential treatment” principle would apply, such that a taxpayer would be given a choice between claiming a tax deduction under section 16(1) and claiming a tax credit under section 50, whichever is more beneficial to the taxpayer.

Mr Wong said the simple answer was yes. Hong Kong adopted the “preferential treatment” principle. Preference would be given to the provisions that were most beneficial to taxpayers.

(f) 183-day exemption from Hong Kong salaries tax

It is mentioned in the recent Guoshuifa [2010] No. 75, ("Circular 75") concerning Mainland China/ Singapore CDTA that an individual would qualify as a tax resident of Mainland China for CDTA purpose if he spends one full year in the Mainland. Circular 75 is used to determine whether an individual is a tax resident of Mainland China in the context of other CDTA which has similar article.

The Institute would like to seek the IRD's view as to whether the IRD would accept the 183-day exemption claim lodged by an individual in his Hong Kong individual tax return (as a tax resident of Mainland China), where the individual is a Hong Kong permanent identity card holder who:

- (i) is employed by a company located in the Mainland;
- (ii) lives with his family in the Mainland;
- (iii) obtains a tax resident certificate from the Chinese local tax bureau by reason of staying one full year in the Mainland (but less than five consecutive full years and therefore is not subject to Mainland China individual income tax on his worldwide income); and
- (iv) fulfilled the three conditions under the 183-day exemption for employment income in Hong Kong.

Mr Chiu advised that whilst the IRD had taken note of Guoshuifa [2010] No. 75 concerning the CDTA between the Mainland and Singapore, it might not be appropriate for the IRD to make any comments on it.

Mr Chiu explained that in practice, the IRD would not readily accept the 183-day exemption claim lodged by an individual in his Hong Kong Individuals Tax Return and that the taxpayer was a tax resident of the Mainland. The IRD would examine other relevant factors to decide whether the individual could also be regarded as a Hong Kong resident, e.g. he was still ordinarily residing in Hong Kong. If the individual was a resident of both Hong Kong and the Mainland, the tie-breaker rule would be applied to decide ultimately whether the individual was a Hong Kong or Mainland resident.

(g) Tax credit under Hong Kong salaries tax

It is mentioned in paragraph 114 of DIPN 44 that a tax exemption claim under section 8(1A)(c) generally provides greater tax relief than that provided by tax credit under CDTA.

The Institute requests the IRD to consider illustrating this with numerical examples comparing the tax relief under section 8(1A)(c) with a tax credit. The first example could illustrate where a section 8(1A)(c) claim is more favourable than tax credit and the second example, where a tax credit is more favourable than a section 8(1A)(c) claim.

Mr Wong referred to Agenda Item A4(d) of the 2009 minutes and advised that a similar question was raised in the 2009 meeting. As explained, it would be difficult for the IRD to offer taxpayers suggestions since the facts of each case could be complex with different permutations.

Mr Wong explained that generally, if a taxpayer made a claim under section 8(1A)(c) instead of a tax credit under section 50, he would continue to be granted basic and other allowances in full against his assessable income (after excluding the income derived from an overseas jurisdiction in which foreign tax had been imposed) which was subject to lower marginal rates. In Example 6 at paragraph 132 of DIPN 44, if the individual lodged a claim under section 8(1A)(c), income derived by him from services rendered in the Mainland, which had been subjected to Individual Income Tax, would be excluded from his assessable income. Since the net assessable income (i.e. assessable income after deduction of expenses) was smaller than his personal allowance, the individual would not be subject to salaries tax.

CIR concluded that despite the fact that apparently the exemption under section 8(1A)(c) would produce a favourable result in most cases, a taxpayer still had the option to choose which tax relief was to be pursued to his best advantage under different circumstances.

(h) Mutual agreement procedures under a CDTA

In agenda item A4(c) of the 2010 minutes, the IRD provided some examples of cases where a request for MAP would be justified. In this regard, the Institute would like to ask:

- (i) If the IRD has processed any request for a MAP.
- (ii) If so, the nature of the MAP involved.

Mr Wong advised that the IRD had not processed any request for a MAP at this stage. In reply to a question from Ms Macpherson, Mr Wong replied that a Hong Kong resident had to demonstrate that the actions of one or both of the contracting parties result or would result in taxation not in accordance with the provisions of the CDTA before the IRD could start MAP with the competent authority of the other contracting party.

Further, the Institute would like to seek the IRD's view on the following situation:

- (iii) A Hong Kong taxpayer ("HKCo") has sought an advance ruling from the IRD on the transfer price in respect of transactions with its group entity residing in a jurisdiction with which Hong Kong has signed a CDTA (say the Mainland, "PRCCo"). PRCCo then requests an advance pricing agreement ("APA") with the Mainland tax authority regarding HKCo-PRCCo transactions. If the outcome of the APA deviates from the advance ruling made by the IRD, the Institute would like to ask if the IRD would accede to a MAP request made by HKCo.

Mr Wong advised that a contracting party had to ascertain whether there was a prima facie or justifiable case before entertaining a request for MAP under a CDTA. A person could only request for MAP if the actions of one or both of the contracting parties resulted or would result for him in taxation not in accordance with the provisions of the CDTA.

Mr Wong explained that paragraph 64 of DIPN 45 (Relief from Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments) set out the circumstances in which the Commissioner would not consider there was a justifiable case for MAP.

Mr Wong further explained that in the circumstances mentioned by the Institute, the IRD did not consider that there was a prima facie case for MAP as it was premature to conclude there would be taxation not in accordance with the provisions of the CDTA simply because the outcome of the APA deviated from the advance ruling made.

- (iv) It is noted that the Japan DTA and Luxembourg protocol have specified articles for arbitration. The Institute requests IRD to provide more details of the mechanism and whether arbitration articles will be included in future CDTAs.

Mr Wong advised that the OECD in its Model Tax Convention issued in July 2008 introduced the arbitration provisions and it was now an international trend to adopt these provisions. These provisions would be adopted in the CDTAs if Hong Kong and its treaty partners both considered it desirable and appropriate to do so. The OECD Model Tax Convention contained a sample agreement for implementing the arbitration provisions, which would form the basis of the IRD's negotiation with Hong Kong's treaty partners. CIR said that, currently, three of Hong Kong's CDTAs contained arbitration provisions.

Agenda item A5 - Departmental policy and administrative matters

(a) Employer's withholding obligation under Hong Kong salaries tax

An employer is required to comply with the withholding requirement under section 52(7) to withhold from making any payment of money or money's worth to or for the benefit of the employees who are about to depart from Hong Kong, for a period of one month from submitting the notice required under section 52(6) (which is the Form IR56G). In relation to this, the Institute would like to clarify the following:

In the case where the employees would exercise stock options or be vested with restricted shares within the one month withholding period, it would be difficult for the employers to comply with the withholding requirement because (i) there is no payment of cash by the employer to the employees and (ii) the transactions of exercise and vesting would be handled directly by intermediaries such as banks and brokerage houses. As there is no payment by the employer to the employee, would the IRD accept and/ or agree that the employer is not required to comply with the withholding requirement on the income derived from the stock option exercised or restricted shares vested in these circumstances? If not, can the IRD provide any practical suggestions to the employer for complying with the withholding requirement?