



25 August 2005

**Urgent by fax (2511 7414) and by post**

Your Ref.: DAD(CR)483/141-14C

Our Ref.: C/TXG, M36462

Inland Revenue Department  
36/F, Revenue Tower  
5 Gloucester Road  
Wanchai  
Hong Kong

(For the attention of Mrs. Leung Lam Sau-mei)

Dear Sirs,

**Double Taxation Arrangement with the Mainland**

We refer to your letter dated 14 June 2005 requesting our comments, in connection with the discussion to be held in early September 2005 between the Inland Revenue Department (“IRD”) and the State Administration of Taxation, on expanding the Double Taxation Arrangement with the Mainland (“Arrangement”).

At the Institute’s Taxation Interest Group discussion forum held on 16 August 2005 (“TIG discussion forum”), the IRD indicated that a comprehensive or full double tax arrangement (“DTA”) would be proposed to be entered into between Hong Kong and the Mainland. Before commenting on the areas that the Institute believes should be covered by the Arrangement taking into account the problems with its existing provisions, the Institute would emphasise the importance of the Hong Kong Government clearly demonstrating to the local community the benefits for Hong Kong entering into a comprehensive DTA with the Mainland, having in mind the special circumstances of Hong Kong’s territorial taxation system, and its attractiveness to foreign investors as a place for setting up their businesses.

We understand that the IRD is conducting a separate consultation on whether Hong Kong should liberalise the “Exchange of Information” provision when negotiating for a comprehensive DTA between Hong Kong and other places, which will close on 15 September 2005. This is a sensitive area and one that causes concerns in Hong Kong, particularly for those involved in Hong Kong-Mainland cross border transactions. Care should be taken to ensure reaching a consensus on the matter in Hong Kong. If the public strongly opposes inclusion of an exchange of information provision in the Arrangement, Hong Kong should seek to expand the scope of the existing Arrangement by incorporating some of the suggestions set out below, without an exchange of information provision, rather than negotiating with the Mainland for a comprehensive DTA, which would normally contain an exchange of information provision.

The IRD also indicated at the TIG discussion forum that the exchange of information provision in the 1995 version of the OECD model convention would be considered for inclusion in the Arrangement.

With a view to allaying concerns in Hong Kong, it is suggested that the IRD should consider providing more information to the public on the version and the limited scope of the exchange of information provision being proposed, apart from demonstrating the merits of entering into a comprehensive DTA with the Mainland.

## 1. The Arrangement

### (a) Scope

The existing Arrangement covers mainly income from business operations and employment income but does not cover withholding tax on passive income such as interest, royalties, dividends and capital gains. Despite the various tax-related and other advantages of Hong Kong as a regional base for multinational companies, e.g. application of the territorial taxation system, geographic proximity to the Mainland, and the availability of support by way of professional and financial services, Hong Kong appears to be increasingly less competitive than other jurisdictions, including Singapore, Delaware (US), Mauritius and the British Virgin Islands, as a place for multinational corporations (“MNCs”) and other foreign investors to set up intermediate holding companies or regional management headquarters for their PRC investments.

To enhance Hong Kong’s attractiveness to foreign investors as a place for setting up holding companies or regional headquarters, Hong Kong should seek to benefit from at least the most preferential tax treatment similar to that offered by the Mainland to any other jurisdiction.

### (b) Definition of Resident

While the meaning of a resident (individual or company) is explained in the Departmental Interpretation and Practice Notes No.32, it is not defined in the existing Arrangement. As suggested in the Institute’s submission dated [19 November 2003](#) on proposed DTAs to be entered into between Hong Kong and other jurisdictions (Appendix 1), it is fundamental in drafting a DTA that it should be absolutely clear as to the individuals and companies to which it applies. The meaning of a resident should therefore be clarified in the Arrangement.

## 2. To promote Hong Kong as a "regional hub" for foreign investors to set up holding companies or regional headquarters for their PRC investments

Taking into account the level of direct investment in the Mainland from Hong Kong, Hong Kong should, in negotiating with the Mainland, seek to enjoy tax treatment at least as favourable as that provided for in some of the existing DTAs entered into between the PRC and other jurisdictions as set out below.

### (a) Permanent Establishment ("PE")

Under most of the DTAs which the PRC has entered into with other jurisdictions, the normal "safe harbour" period in relation to the "furnishing of services, including consultancy services" is "6 months within any 12-month period".

However, a longer safe harbour period is provided for under the PRC-Mauritius DTA, i.e. "*...the furnishing of services, including consultancy services, by an enterprise of a Contracting State through employees or other personnel engaged in the other Contracting State, provided that such activities continue for the same project or a connected project for a period or periods aggregating more than 12 months within any 24 months period...*".

A longer safe harbour period would serve to encourage foreign investors to adopt Hong Kong as their "regional international assignment centre" for the residence of expatriates from different jurisdictions that are on work assignments in the Mainland.

A longer safe harbour period would also encourage foreign contractors, who are conducting business in the Mainland on a project-by-project basis, to set up companies in Hong Kong in order to conduct their Mainland projects from Hong Kong.

### (b) Withholding Taxes

As suggested above, Hong Kong should seek to negotiate with the Mainland for at least the most preferential tax treatment similar to that offered by the Mainland to any other jurisdiction. Nevertheless, to facilitate the negotiation process, our suggestions with respect to the provisions on withholding taxes are set out below according to an order of priority. Firstly, the provision on capital gains with preferential tax treatment (see below under "Capital Gains") could serve to enhance the attraction of Hong Kong as a location for setting up holding companies, followed by the provision on interest, which is important in terms of the amount of tax revenue involved, and the provision on dividends, and, lastly, the provision on royalties (under the sections regarding promoting Hong Kong as a research and development centre and as an equipment leasing centre).

**(i) Capital Gains**

Under Mainland law, a 10% withholding tax is chargeable on capital gains.

Preferential tax treatment is provided in the PRC-Barbados DTA, such that gains from the alienation of any property (other than immovable property; movable property forming part of the business property of a PE; ships or aircrafts operated in international traffic) "shall be taxable only in the Contracting State of which the alienator is a resident" (Article 13(4)).

It is suggested that Hong Kong should endeavour to negotiate an article on capital gains that is no less favourable to Hong Kong than the corresponding provisions in the PRC-Barbados DTA. The wording of [Article 13](#) of the PRC-Barbados DTA is set out in Appendix 2.

Including a provision in the Arrangement with wording similar to Article 13(4) of the PRC-Barbados DTA would mean that gains derived by a Hong Kong company from the disposal of a subsidiary company in the Mainland would be exempt from Mainland capital gains tax.

**(ii) Interest**

Under Mainland tax law, Circular GuoShuiFa (1997) No. 186 provides for a temporary withholding tax exemption on interest paid by Foreign Invested Banks to Overseas Financial Institutions.

Under Article 11 of the PRC-Kuwait DTA, a 5% withholding tax applies to the gross amount of interest. Under Article 11 of the PRC-Macau DTA, for example, the withholding tax rates on interest are as follows:

- 7% of the gross amount of the interest gained by banks or financial institutions;
- 10% in any other circumstance.

To promote Hong Kong as an international financial centre and as gateway to the Mainland, it is suggested that Hong Kong should endeavour to negotiate an article on interest that is no less favourable to Hong Kong than the corresponding article in the [PRC-Macau DTA](#), as set out in Appendix 3.

**(iii) Dividends**

Under Mainland tax law, after-tax dividends paid by Foreign Investment Enterprises to foreign investors are currently exempt from withholding income tax, but this position may be subject to review in the impending income tax reform in 2007.

A 10% withholding tax applies to dividends under most of the DTAs that the Mainland has entered into with other jurisdictions. However, a 5% withholding tax applies under the PRC-Mauritius and PRC-Barbados DTAs (Article 10).

Under the DTA entered into between Hong Kong and Belgium, for example, the dividends paid by a company, which is a resident in a Contracting Party, to a resident in the other Contracting Party may be taxed in the Contracting Party at the rate of 5% of the gross amount of the dividends, if the beneficial owner of the dividends is a company which holds directly at least 10% of the capital of the company paying the dividends (Article 10).

Hong Kong should seek to negotiate with the Mainland for a maximum of 5% withholding tax to apply to dividends.

### **3. To promote Hong Kong as a research and development centre**

Under most of the DTAs entered into between the PRC and other jurisdictions, the withholding tax rate on royalties generally is 10%.

To provide an incentive for investors to set up and maintain their research and development centres in Hong Kong for the purpose of licensing the right to use the technology developed in Hong Kong to Mainland licensees, and to promote Hong Kong as a hub for intellectual property development and promotion with respect to, e.g. trademarks and film exhibition rights, Hong Kong should endeavour to negotiate an exemption from PRC withholding tax for royalties paid by Mainland residents to Hong Kong residents.

### **4. To promote Hong Kong as an equipment leasing centre**

Under most of the DTAs entered into between the Mainland and other jurisdictions, the withholding tax rate on royalties for equipment leasing is 10%. Under the PRC – the Netherlands DTA, the withholding tax rate on royalties is 6%.

To promote Hong Kong as a hub for equipment leasing, Hong Kong should endeavour to negotiate an exemption from PRC withholding tax for royalties paid by Mainland residents to Hong Kong residents.

### **5. PRC tax credit for dividends paid by a Hong Kong company to Mainland investors**

Under Hong Kong law, no withholding tax applies to dividends paid by a Hong Kong company to its foreign investors. A Mainland investor receiving dividends from a Hong Kong company will not be entitled to a PRC tax credit in relation to the dividend income under paragraph 1 of Article 4 of the Arrangement.

We would propose including in the Arrangement an article similar to paragraph 1(b) of Article 23 of the PRC-UK DTA, i.e.:

*“Where the income derived from the Hong Kong Special Administrative Region is a dividend paid by a company which is a resident of the Hong Kong Special Administrative Region to a company which is a resident of the Mainland of China and which owns more than 10 per cent of the shares of the company paying the dividend, the credit shall take into account the Hong Kong Special Administrative Region tax payable by the company paying the dividend in respect of [the profits out of which such dividend is paid<sup>1</sup>].”*

Under the proposed provision, a Mainland investor receiving dividends from a Hong Kong company would be entitled to a Mainland tax credit for the Hong Kong profits tax paid in respect of the underlying profit of the Hong Kong company. This would enhance the attractiveness of Hong Kong to Mainland investors.

## **6. To encourage exchange of education between Hong Kong and Mainland China – Teachers and Researchers**

Currently, there are a large number of degree (e.g. MBA) programmes organised jointly by the universities in Hong Kong and the Mainland. Some of the Hong Kong individuals involved provide lectures on a regular basis at the Mainland universities over a period for 1 - 2 years (depending on the length of the programme).

The PRC tax issues for these individuals are twofold:

- (i) Firstly, the definition of permanent establishment (“PE”) is unclear and they may not be eligible to exemption under the 183 day rule. This is because, as the classes for such degree programmes are conducted in classrooms provided by the Mainland universities on weekends, over, say, a 2-year duration, the classrooms would be viewed as a fixed place, based on the current definition of a PE.
- (ii) Secondly, if these individuals are taxed in the Mainland, their salaries in Hong Kong and the Mainland would be aggregated to compute the PRC individual income tax payable, and pro-rated according to the number of days in which they are present in the Mainland.

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<sup>1</sup> The original wording used in paragraph 1(b) of Article 23 of the PRC-UK DTA is “income”. However, the mirroring paragraph for the Chinese tax credit (Paragraph 2(b) of Article 23) of the PRC-UK DTA uses the phrase “the profits out of which such dividend is paid”.



The PRC-Macau and PRC-Barbados DTAs provide for a 3-year and 2-year exemption from PRC individual income tax respectively, for accredited educational programmes (Article 20). It is suggested that Hong Kong should negotiate for similar tax exemptions/concessions for accredited educational programmes as provided for in the PRC-Macau and PRC-Barbados DTAs (Article 20).

Assuming that no tax exemptions/concessions are to be offered to the individuals concerned, it is suggested that their Mainland individual income tax liability should be based solely on their teaching income derived in the Mainland, without aggregating it with the Hong Kong-sourced income, which are distinctly identifiable incomes from two separate sources. It is suggested that the "day-in-day-out" rule, which is more appropriate for ascertaining the Mainland individual income tax liability of traders, whose Mainland-sourced income is not distinctly identifiable, should not apply to individuals in the circumstances of the relevant university staff.

## **7. Transfer pricing – introducing corresponding adjustments**

Transfer pricing issues have become a topic of concern since the tax holidays previously enjoyed by most of the PRC Foreign Investment Enterprises came to an end, around 1999 or 2000. Some of the transfer pricing adjustments may have been made due to a transfer pricing policy not being acceptable to the Mainland tax authorities, rather than as a result of tax evasion.

For example, the transfer price for the finished goods purchased by a Hong Kong company from its Mainland manufacturing subsidiary companies may be adjusted upward by the Mainland tax authorities, thus effectively taxing a portion of the profit derived by the group twice.

In such cases, the Hong Kong company would not be able to rely on section 70A of the Inland Revenue Ordinance to claim back the Hong Kong tax paid, as the IRD would not accept such an adjustment as an "error" or "omission". There is currently no system in place between Hong Kong and the Mainland to avoid the double taxation on income that arises from transfer pricing adjustments on either side. Legislative amendments may be required to be introduced in Hong Kong to allow taxpayers to claim back the tax previously paid where a transfer pricing adjustment is made by the other side.

It is suggested that the Arrangement should be expanded to provide for corresponding transfer pricing adjustments to enhance certainty to taxpayers and reduce compliance and administration costs. According to the draft minutes of the 2005 Annual Meeting between the IRD and Institute, under Agenda Item A5 (Guoshuifa [2004] No.143), the possibility of providing for corresponding transfer pricing adjustments under the Arrangement would be permitted in the context of a comprehensive DTA, and the IRD is working towards this direction.



If corresponding transfer pricing adjustments are to be provided for under the Arrangement, it would be appropriate to provide guidance by way of new Departmental Interpretation and Practice Notes to minimise confusion.

#### 8. Other matters

--- The comments expressed by the Institute in its submission dated [3 March 2004](#) (Appendix 4) on the wording of the Hong Kong-Belgium DTA, and in the submission dated 19 November 2003 (Appendix 1) on proposed DTAs to be entered into between Hong Kong and other jurisdictions, are also relevant in the context of negotiating amendments to the Arrangement.

We trust that you find our comments to be constructive. If you have any comments or questions in relation to the above, please feel free to contact our John Tang, Assistant Director, Specialist Practices at [john tang@hkicpa.org.hk](mailto:john tang@hkicpa.org.hk) or at 2287 7006.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Stephen Chan', with a long, wavy horizontal line extending to the right.

Stephen Chan  
Executive Director

SSLC/JT/ay  
Encls.