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Structuring Implications of the New Double Tax Arrangement between Mainland China and Hong Kong

Hong Kong has been the main source of foreign direct investments into Mainland China, implying that most foreign investors hold their mainland subsidiaries and operations through Hong Kong companies. This phenomenon is contrary to conclusions of pure tax analyses, which typically suggest places like Mauritius or Barbados are better choices due to tax treaty benefits. This should not be surprising because Hong Kong offers many other advantages, such as proximity to operations and logistic efficiency that override tax treaty considerations.

The new or extended double taxation arrangement (“the Arrangement”) signed on August 21, 2006 between Hong Kong Special Administrative Region (“Hong Kong”) and the Mainland (“China”) goes further to reinforce the position of Hong Kong as the gateway to China; it is also a reemphasis of Hong Kong’s advantage for firms on the Mainland looking for opportunities overseas. Our recent Tax Alert has provided the salient features of the Arrangement and this note looks at its structuring implications for inbound activities.

On flows of know-how and capital (including equities, loans, properties)

The more noticeable benefits of the Arrangement are reduction or exemption of withholding tax on dividends, interest, royalties and capital gains.

Dividends received by foreign investors from a foreign invested enterprise are now tax exempt in China. If this exemption is uplifted, Hong Kong incorporated recipients of such dividends are only subject to 5% withholding tax, while unincorporated recipients, 10%, as compared to the standard rate of 20% and most other treaty rates of 10%.

Withholding tax on interest and royalties is reduced to 7% in general, where such income is not connected with a permanent establishment in China. Note that interest is defined as income from debts-claims of every kind; accordingly, premiums, prizes attaching to securities and profits attributed to hybrid loans are all interest by definition. Also royalties are broadly defined to cover payments of any kind for the use or right to use of a wide spectrum of intellectual properties and know-how.

There are in effect transfer pricing provisions in the Arrangement relating to interest and royalties. The provisions govern the allocation of taxing rights between China and Hong Kong where such payments are made between parties with a “special relationship” but not made in accordance with the arm’s length standard. An adjustment would be made to determine what would have been an arm’s length payment and the corresponding “excess part”. The arm’s length payment and the excess part are then taxed according to respective domestic rules.

The taxation of capital gains is more complex in that the nature of property must be firstly identified for determining the effect of the Arrangement. For the purpose of the Arrangement, properties are classified as follows:

1. Immovable property (in China)
2. Movable property that forms part of a permanent establishment (in China)
3. Means of transport including ships, aircraft, land transport and pertaining movable properties

- (probably used in and outside China)
4. Shares in a company whose assets comprise mainly, directly or indirectly, immovable property (in China)
 5. A non substantial (less than 25%) holding of shares in a company (in China and companies mentioned in 4 excepted)
 6. Other properties not mentioned above

Gains made by a Hong Kong resident from the disposal in China of assets in categories 1, 2, 4 are taxable in China.

The right to tax gains from the disposal of assets in categories 3, 5 and 6 is allocated to Hong Kong. Since Hong Kong does not tax capital gains, it is most likely such gains are not taxable in both jurisdictions.

Complexities relating to gains from sale of shares

When structuring the above flows, one must pay particular attention to the following matters: (1) the existence of a permanent establishment; and (2) flows involving properties in categories 4 and 5. We shall deal with the issue of permanent establishment later. Let's firstly look at issues relating to the sale of properties in categories 4 and 5.

Shares in companies holding immovable properties

Article 13, paragraph 4 states:

"Gains derived from the alienation of shares in a company the assets of which are comprised, directly or indirectly, mainly of immovable property situated in One Side (i.e. China, in the context of this note) may be taxed in that Side (i.e. China)"

Article 3, under General Definitions:

"the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes"

The literal interpretation of Article 13 with the assistance of Article 3 suggests gains from the disposal of shares in any body corporate whose assets are comprised mainly, directly or indirectly, of immovable property in China are taxable in China. In other words, it does not matter whether the body corporate is a company incorporated in China or outside China; and it does not matter how the corporate relations are formed as long as the interest in such shares relates ultimately to immovable properties situated in China.

If the Chinese tax authorities pursue the above line of argument, gains from a sale of shares in any companies, including foreign companies, indirectly holding immovable properties in China are taxable in China, enforcement issue aside. One logical response to this conclusion is foreign investors should never use a Hong Kong company to hold shares in a company that in turn owns however indirectly immovable properties in China as primary assets; it is because this issue arises from the interpretation of Article 13 of the Arrangement.

This response is problematic in two respects: one, similar provisions exist in most other double tax arrangements China has entered into; two, even for a company formed in a jurisdiction that does not have double tax arrangement with China, China may still claim that gains from the sale of such shares are China sourced under the usual territorial principle. The question then is whether China can enforce the claim. With immovable properties in China, that should provide sufficient nexus for enforcement.

This is a matter property funds or real estate investment trusts ("REIT") designed to invest in and hold properties in China should clarify.

Shares of non substantial holding in a company (below 25%)

When announcing the signing of the Arrangement, the Hong Kong SAR Government states in the announcement:

“The taxing right for gains received by a Hong Kong resident or a Hong Kong business from the transfer of shares in a Mainland enterprise is allocated exclusively to Hong Kong. If the income does not amount to a trading receipt or is not sourced in Hong Kong, no profits tax will be charged in Hong Kong.”

The announcement continues:

“In the case where...the shares transferred are equal to or exceed 25% of the shareholding of the Mainland enterprise, the income may be taxed in both jurisdictions. However, a tax credit arrangement will effectively ensure that the same income will not be taxed twice.”

Wording in the above announcement does not correspond exactly to Article 13, paragraph 5 of the Arrangement, which reads:

“Gains derived from the alienation of shares, other than the shares referred to in paragraph 4 (see above), of not less than 25% of the entire shareholding of a company which is a resident of One Side (i.e. China in the context of this note) may be taxed in that Side (i.e. China).”

It appears Paragraph 5 is to benefit the holding of a portfolio of shares in companies in China; typically such investments involve non substantial holdings. The line of demarcation is set at 25% of the entire shareholding of a company.

However, the language of paragraph 5 appears to have given investors argument for a greater advantage; that is, the threshold of 25% applies to the quantity of shares being alienated. Accordingly, one may avoid the tax on gains by disposing of a substantial holding of shares piecemeal. This argument is actually supported by wording used in the above announcement.

Nevertheless, as we understand it, at least some Chinese tax officials resist this interpretation on the basis that it was not the intention of the provision which refers to alienation of “shares of not less than 25% of the entire shareholding of a company”. No wording used in the Arrangement (both in the Chinese and in the English version) refers to “shares transferred” which is the wording used in the announcement.

Permanent establishment

Permanent establishment (“PE”) is one of the most difficult concepts in international taxation. The main questions one should look at in this respect include: how a PE may come into existence as a result of the cross border flows of capital, goods, personnel and associated activities; whether a transaction is connected with a PE if its existence does occur; how income from a transaction is attributed to the PE; and how tax liability is determined and settled.

The application of the PE concept is even more difficult in the context of Hong Kong and Mainland cross border business because a large number of such business are carried out in the form of hybrid structures, being a combination of foreign entities and domestic entities, involving a large number of people with dual residence. Complexities in this regard are dealt with under Article 4 (Residence) and Article 5 (PE) and Article 7 (Business Profits) of the Arrangement.

On dual residence, Article 4 uses a number of concepts to clarify the status of a person including permanent home, center of vital interests, habitual abode and place of effective management which is also regarded as PE by definition.

Definition, inclusions and exclusions

On PE, Article 5 defines it as a “fixed place of business” through which the business of an enterprise is wholly or partly carried on. It should be noted from the outset that despite this definition, a fixed place of business may not give rise to a PE due to exclusions in paragraph 4 and a place not normally considered

fixed can be a PE by way of inclusions in paragraphs 2 and 3. Paragraphs 5 and 6 discuss the circumstances in which agents are or are not treated as PE of the principal. In general, non exclusive independent agents acting in the course of normal business escape the charge. These provisions have significant implications for cross border structuring.

Determination of profits

On the extent of liability, Article 7, paragraph 1 says, a Hong Kong enterprise carrying on business through a PE in China is only taxable to the extent its profits are attributable to the PE. In determining the quantum of attributable profits, for a long time, as a matter of practice, PE is generally taxed on a deemed profit basis. At times, this may be favorable where a taxpayer can by way of negotiation obtain a low deemed profit rate or a generous proxy for a small tax base. However, a proxy based deemed profit tax does not allow taxpayer to obtain the full benefit of tax deductible expenses such as interest and does not allow tax losses. One problem of this practice is that the result of negotiation is often not well documented and hence subject to reopening, a risk that taxpayers may not like to live with.

Paragraph 3 makes it clear that a PE may choose to be taxed on a net income basis, allowing expenses incurred in and outside China for the purpose of the business of the permanent establishment. In general, however, the mutuality principle applies to disallow internal charges except for banking enterprises. This is not unfair and can be managed with well reasoned and documented inter-company, as opposed to intra-company charges.

Reviewing practice of hybrid structures

Paragraph 4 provides a most interesting element: allowing profits attributable to PE to be determined by apportioning the total profits of an enterprise and most importantly, the result of such apportionment should be in accordance with principles in Article 7. This must be referring to, in the main, the principle in Paragraph 2, which is in effect the arm's length principle.

“...there shall in each side be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.”

This is an important departure from a long established practice, closely guarded by the Hong Kong Inland Revenue. The Hong Kong Revenue has been taxing HK-Mainland hybrid structures on a profit apportionment basis but apportionment can only be made on a 50/50 basis irrespective of the proportion of activities and resources deployed in Hong Kong and on the Mainland. While this broad brush approach to apportionment is arguably time-saving, it is not necessarily cost-saving from the taxpayers' perspective. And, more importantly, it is not necessarily economically optimal; it is because attributing one-half of the total profits to a small operation would result in exceptionally high effective tax burden on the small operation. The result is economic distortion and involuntary capital shift resulting in unnecessary destruction of jobs. We therefore applaud the change.

This change calls for all enterprises using hybrid structures for conducting cross border operations to reevaluate this option. On one hand, the Hong Kong profits tax filing position should be revisited to determine what could be the result of an economically rational apportionment that reflects the arm's length principle. On the other hand, the current tax filing position on the Mainland should also be reviewed considering the effect of a net income based PE assessment. One should also anticipate that the Mainland tax administration may become more assertive applying the net income based assessment, given the provisions on exchange of information in the Arrangement.

It is advisable to have the review done before the enactment of the integrated corporate income tax law, which may take place in early 2007 while implementation is speculated to be in 2008. It is because under the current foreign enterprise income tax regime, foreign investors including Hong Kong operators have a better chance of preserving their favorable China tax positions under the hybrid structure.

General & special advantages of the Arrangement

To conclude, we would highlight a number of advantages offered by the Arrangement.

In general, the generously low withholding tax rates provided by the Arrangement make Hong Kong a favorable choice as a base for managing the flows of capital, know-how and creativity between Hong Kong and Mainland China. As Hong Kong is an open economy that does not tax capital gains and offshore investment income with very limited transaction tax exposure, Hong Kong is uniquely positioned as gateway to China for the rest of the world.

The Arrangement also offers special advantages to certain industries, using Hong Kong as a base to hold and manage investments and operations in China.

In particular, the logistics industry enjoys complete exemption from income tax of profits from the operation of ships, aircraft and land transport vehicles and the exemption extends to profits derived from partnership, joint venture and international agency. As mentioned above, capital gains from the disposal of transport assets are also tax exempt in China. The territorial based Hong Kong profits tax, capital gains exemption and accelerated depreciation would provide further advantages to a Hong Kong based structure for cross border logistics operations.

While the intended effect of the Arrangement on the sale of shares in a Chinese company need clarification, it is clear that gains from the sale of portfolio shares of non substantial holding are not taxable in China and in Hong Kong. This tax advantage makes Hong Kong possibly the best place as the base for managing funds and assets in China, considering Hong Kong's proximity to the investments and Hong Kong's excellent infrastructure in this regard. One thing fund managers should find out is whether gains from sale of shares and securities in an offshore REIT are subject to tax as income sourced in China, as explained.

Finally, the effect of remodeling the practice of taxing PE in China should not be underestimated. The Arrangement provides generous exclusions to what may constitute a PE. Together with rules on determination of income attributable to a PE and Hong Kong's unique cross border operational capability, structuring transactions and operations through a Hong Kong entity is a choice no planners can ignore.