Hong Kong Taxation of Non-Residents

Fergus Wong
National Tax Policy Services
PricewaterhouseCoopers

28 August 2012

---

**Agenda**

- Treaty developments in Hong Kong
- Taxation issues of Treaty resident companies in Hong Kong
- Taxation issues of Treaty resident individuals in Hong Kong
- Q&As
Treaty developments in Hong Kong

Developments of Hong Kong’s treaty network

Pre Dec 2008:
2. Thailand (2005)
4. Luxembourg (2007)

Year 2010:
6. Brunei
7. Netherlands
8. Indonesia
9. Hungary
10. Kuwait
11. Austria
12. UK
13. Ireland
14. Liechtenstein
15. France
16. Japan
17. New Zealand

Year 2011:
18. Portugal
19. Spain
20. Czech Republic

Year 2012:
21. Switzerland
22. Malta
23. Jersey
24. Malaysia
25. Mexico

25 agreements signed, 22 adopt 2004 OECD EoI article
Taxation issues of non-resident companies in Hong Kong – HK domestic law and guidance

Business operations in HK

Relevant provisions in HK tax legislation

Taxation of a NR company with business operations in HK:

<table>
<thead>
<tr>
<th>Section 14 of the IRO</th>
<th>The basic charging section setting out the scope of charge i.e. only HK sourced profits from a trade or business carried on in HK are chargeable, whether a PE exists is irrelevant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inland Revenue Rule 5 (IRR 5)</td>
<td>• Definition of a Permanent Establishment ✓ A branch; ✓ Management; ✓ Other place of business; ✓ An agent that has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principle; or ✓ An agent that has a stock of merchandise from which he regularly fills orders on behalf of his principal</td>
</tr>
<tr>
<td></td>
<td>• Quantification of HK sourced profits of a PE in HK</td>
</tr>
</tbody>
</table>
Relevant provisions in HK tax legislation

IRR 5 – Ascertaining profits of a PE in HK

1. Actual profits method
   • True HK sourced profits disclosed in the accounts

2. World profit margin method
   • HK sourced profits = Worldwide profits × HK Turnover / Worldwide Turnover

3. % of turnover method
   • A fair % of the HK turnover as determined by the assessor
   • Apply when it is impracticable or inequitable to adopt methods 1 and 2

Case precedents

Taxation of a NR company in HK:

<table>
<thead>
<tr>
<th>Case law on source of profits</th>
<th>Trading profits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sinolink / Exxon Chemical / EuroTech / Magna / Consco cases</td>
</tr>
<tr>
<td></td>
<td>Places where the sale and purchase contracts are “effected”</td>
</tr>
<tr>
<td></td>
<td>“Totality of facts” approach</td>
</tr>
<tr>
<td>Brokerage commission income</td>
<td>ING Baring case</td>
</tr>
<tr>
<td></td>
<td>Execution of share transactions at the stock exchange</td>
</tr>
<tr>
<td></td>
<td>“Effective cause” approach</td>
</tr>
<tr>
<td>Service fee / commission income</td>
<td>Li &amp; Fung case</td>
</tr>
<tr>
<td></td>
<td>Follow the principle in ING Baring</td>
</tr>
<tr>
<td>Manufacturing profits</td>
<td>Datatronic / C G Lighting cases</td>
</tr>
<tr>
<td></td>
<td>Not common for PEs in HK</td>
</tr>
</tbody>
</table>
**DIPNs issued by the IRD**

Taxation of a NR company in HK:

| Revised DIPN 21 (December 2009) | • IRD’s interpretation and practice on source of profits  
| • Not legally binding  
| • Broad guiding principle – “Look at what the taxpayer has done to earn the profits and where he has done it”  
| • Reference to the case law  
| • A HK branch acting as a buying office  
| • Source of sale or purchase commission – where the activities of the commission agent are performed  
| • Apportionment is possible for certain income e.g. service fees |

---

**Taxation of Treaty Resident Companies in Hong Kong - Treaty provisions and international practice**

**Business operations in HK**
Permanent Establishment – Article 5

- Permanent Establishment – Widely adopted by many jurisdictions as the threshold triggering corporate tax exposure of non-resident (NR) companies on active business income under a treaty

- Not a critical concept for HK domestic tax law in the past due to the unique features of the HK tax system

Relevant articles in the Hong Kong treaties

Taxation of a PE:

<table>
<thead>
<tr>
<th>Article 5 on PE</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>A fixed place of business</td>
<td></td>
</tr>
<tr>
<td>A place of management</td>
<td></td>
</tr>
<tr>
<td>A branch</td>
<td></td>
</tr>
<tr>
<td>An office</td>
<td></td>
</tr>
<tr>
<td>A factory</td>
<td></td>
</tr>
<tr>
<td>A workshop</td>
<td></td>
</tr>
<tr>
<td>A mine, an oil or gas well, a quarry or any other place of extraction of natural resources</td>
<td></td>
</tr>
<tr>
<td>A building site or construction or installation project that lasts more than 12 months</td>
<td></td>
</tr>
<tr>
<td>A dependent agent who has, and habitually exercises, an authority to conclude contracts on behalf of the principle</td>
<td></td>
</tr>
<tr>
<td>Provision of services (for the same or a connected project) for more than 6 months in any 12-month period (only in UN Model Tax Convention but common for HK treaties)</td>
<td></td>
</tr>
</tbody>
</table>
### Relevant articles in the Hong Kong treaties

**Taxation of a PE (Cont’d):**

<table>
<thead>
<tr>
<th>Article 7 on Business Profits</th>
<th>Allocation of taxing rights</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Taxing rights of business profits attributable to a PE is given to jurisdiction where the PE is located</td>
</tr>
<tr>
<td></td>
<td>• Corresponding transfer pricing adjustment is required to eliminate double taxation</td>
</tr>
</tbody>
</table>

**Determination of profits attributable to a PE**

- Arm’s length principle – the separate and independent enterprise approach
- Taking into account the functions performed, assets used and risk assumed

### Issues arising from taxation of a PE in HK

<table>
<thead>
<tr>
<th>HK domestic law &amp; guidance</th>
<th>Treaty provisions and OECD rules</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Threshold for tax exposure</strong></td>
<td><strong>Threshold for tax exposure</strong></td>
</tr>
<tr>
<td>• Whether carrying on a trade or business in HK?</td>
<td>• Whether a PE is established in HK?</td>
</tr>
<tr>
<td><strong>Quantification of profits subject to tax in HK</strong></td>
<td><strong>Quantification of profits subject to tax in HK</strong></td>
</tr>
<tr>
<td>• only HK sourced profits are taxable</td>
<td>• only profits attributable to the PE in HK are taxable</td>
</tr>
<tr>
<td>• methods specified in IRR 5</td>
<td>• refer to the OECD transfer pricing principles and guidelines / profits attribution rules</td>
</tr>
<tr>
<td>• adopted the OECD principles and guidelines unless they are incompatible with the IRO provisions</td>
<td></td>
</tr>
</tbody>
</table>

What happens if the two do not produce the same result?
**Case 1 – Brokerage commission income**

HK

- Branch
- Treaty country
  - Execution of stock transactions at the o/s stock exchange based on orders received from HK branch

\[ \$\text{Brokerage commission} \]

HK profits tax implications

1. Domestic
   - Source is the location where the stock transactions are executed based on ING Baring
   - Outcome = The whole brokerage commission income is offshore and not taxable

2. Treaty
   - Taxing right of profits attributable to a PE is given to the jurisdiction where the PE is located
   - Outcome = HK has taxing right on profits attributable to the HK branch under the treaty

**Question:** Should treaty impose tax if domestic law doesn’t?

---

**Case 2 – Trading profits**

HK

- Branch
- Treaty country
  - Negotiation & conclusion of purchase contracts o/s HK

HK profits tax implications

1. Domestic
   - Based on DIPN 21, the whole trading profits are taxable where either the purchase or sale contract is effected in HK and no apportionment is allowed
   - Outcome = The whole trading profits are onshore and taxable

2. Treaty
   - Only profits attributable to the PE as determined by the OECD profits attribution / TP rules are taxable
   - Outcome = Profits attributable to the HK branch as determined under the OECD rules are taxable

**Question:** Should treaty provisions override domestic sourcing rule?
**Case 3 – Service fee income**

### HK profits tax implications

1. **Domestic**
   - Apportionment of service income is acceptable per DIPN 21
   - Service fee income attributable to services performed in HK are regarded as HK sourced
     
     **Outcome =** The part of HK sourced service fee income is taxable

2. **Treaty**
   - Only profits attributable to the PE as determined by the OECD profits attribution / TP rules are taxable
     
     **Outcome =** Profits attributable to the HK branch as determined under the OECD rules are taxable

### Questions:

- Amount of assessable profits determined based on IRR 5 may not necessarily be the same as that determined based on treaty provisions and the OECD profits attribution rules
- What are regarded as “true profits sourced in HK” per IRR 5?
- Which method prevails?
- Should treaty provisions override domestic law?
**DIPNs issued by the IRD**

Taxation of a treaty resident company with business in HK:

| DIPN 45 (April 2009) | • Relief from double taxation in a treaty context  
|                       | • Example 7 - Company in a DTA state with a branch in HK  
|                       |   • Profits attributable to the branch in HK subject to tax in HK  
|                       |   • Tax credit or exemption available in the home country  
|                       |   • Profit reallocation adjustment by the home country results in double taxation  
|                       |   • Ways (including MAP) to resolve the double taxation |

| DIPN 46 (December 2009) | • IRD’s interpretation and practice on transfer pricing issues  
|                         | • Follow the OECD principles unless incompatible with the IRO provisions  
|                         | • Paragraph 71 – Transfer pricing and source of profits |

**Taxation issues of treaty resident companies – HK domestic law and Treaty provisions**

**Receiving Royalties from HK**
**NR companies receiving royalties from HK**

**What are the issues?**

- Rules under domestic law are pretty straightforward:
  - A special regime with deeming provisions
  - A specific anti-avoidance provision for transactions with an associate

- Issues that may arise in a treaty context:
  - What types of income are regarded as royalties?
  - Can domestic anti-avoidance provision be applied to deny reduced rate under treaty?

---

**Relevant provisions in HK tax legislation**

Taxation of royalties derived by a NR company from HK:

<table>
<thead>
<tr>
<th>Sections 15(1)(a),(b) &amp; (ba) of the IRO</th>
<th>Deemed to be receipts arising in or derived from HK from a trade or business in HK if they are not caught under s.14</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cover the following sums:</td>
</tr>
<tr>
<td></td>
<td>- S.15(1)(a) - sums for exhibition or use in HK of cinematograph or television film or tape, any sound recording, or any connected advertising materials</td>
</tr>
<tr>
<td></td>
<td>- S. 15(1)(b) – sums for use or right of use in HK any patent, design, trademark, copyright material, secret process or formula or other property of a similar nature</td>
</tr>
<tr>
<td></td>
<td>- S.15(1)(ba) – sums referred to in s.15(1)(b) which are deductible in ascertaining the assessable profits of a person for HK profits tax purpose</td>
</tr>
</tbody>
</table>
## Relevant provisions in HK tax legislation

Taxation of royalties derived by a NR company from HK (Cont’d):

<table>
<thead>
<tr>
<th>Section 21A(1) of the IRO</th>
<th>For transactions with non-associate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• S.21A(1)(b) – 30% of the sum x 16.5% (effective tax rate is <strong>4.95%</strong>).</td>
</tr>
<tr>
<td></td>
<td>• For transactions with associate and where the intellectual property has been owned by a person carrying on a trade or business in Hong Kong at any time:</td>
</tr>
<tr>
<td></td>
<td>• S.21A(1)(a) – 100% of the sum x 16.5% (effective tax rate: <strong>16.5%</strong>).</td>
</tr>
</tbody>
</table>

## DIPNs issued by the IRD

Taxation of royalties derived by a NR company from HK:

<table>
<thead>
<tr>
<th>Revised DIPN 22 (January 2005)</th>
<th>Objective of introducing the anti-avoidance provision</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Reason for introducing s.15(1)(ba) – <em>the CIR v Emerson Radio Corporation</em> case</td>
</tr>
<tr>
<td></td>
<td>• Application of section 21A</td>
</tr>
</tbody>
</table>
**Relevant articles in the Hong Kong treaties**

Taxation of royalties:

<table>
<thead>
<tr>
<th>Article 12 on Royalties</th>
<th>Allocation of taxing rights</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• May be taxed in the resident state</td>
</tr>
<tr>
<td></td>
<td>• Can also be taxed in the source state but with a reduced withholding rate (normally 3% or 5% for HK treaties)</td>
</tr>
</tbody>
</table>

**Definition of “royalties”**

- Not exactly the same as under domestic law and may include rental for industrial, commercial or scientific equipment (e.g. treaties with Indonesia, the Netherlands, NZ, & Thailand)

**Limitation of benefits**

- Beneficial owner requirement
- Amount to be on arm’s length basis
- Anti-treaty shopping provisions

---

**Issues arising from taxation of royalties derived from HK**

<table>
<thead>
<tr>
<th>HK domestic law &amp; guidance</th>
<th>Treaty provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Definition of royalties</strong></td>
<td>Definition of royalties</td>
</tr>
<tr>
<td>• Sums covered in s.15(1)(a),(b) and (ba) do not include equipment rental</td>
<td>• Article 12 may define royalties to include equipment rental</td>
</tr>
<tr>
<td><strong>Effective tax rate when anti-avoidance provision is applicable</strong></td>
<td>Treaty withholding rate</td>
</tr>
<tr>
<td>• 16.5%</td>
<td>• 5% or 3%</td>
</tr>
</tbody>
</table>

Which one should take precedent - the domestic law or the treaty provisions?
Case 4 – Rental from equipment

HK profits tax implications

1. Domestic
   • Deemed to be taxable trading receipts under s.15(1)(d) of the IRO
     Outcome = The profits derived from renting of equipment is taxable at 16.5%

2. Treaty
   • If the Royalties article covers equipment rental
     Outcome = Gross amount of the rental will be subject to the treaty rate of 5% or 3%
   • If the Royalties article does not cover equipment rental
     Outcome = One has to refer to the Other Income article – HK may not have the taxing right of the rental

Case 5 – Royalties derived from associate

HK profits tax implications

1. Domestic
   • Deemed to be taxable trading receipts in HK and the anti-avoidance provision applies
     Outcome = The royalties are subject to tax at 16.5%

2. Treaty
   • The Royalties article provides for a treaty WHT rate of 5% or 3%
   • The Miscellaneous article provides that domestic anti-avoidance rules may apply to the extent they are not contrary to the treaty provisions
     Outcome = ????
**Taxation issues of non-resident Individuals in a Treaty Context**

*Employment Income – Salaries Tax*

**Hong Kong Employment (s.8(1)):**

- All income are taxable unless exemptions are applicable
- Exemptions:
  - all services rendered outside Hong Kong (s.8(1A)(b))
  - for the part of income of overseas service and foreign tax of similar nature was paid (s.8(1A)(c))
- All services rendered outside Hong Kong?
  - This is a matter of fact (Case D27/03)
  - Services rendered in Hong Kong during visits not exceeding 60 days will not be taken into account (s.8(1B))
- Not applicable to: Office Holder, Government employees, Seafarers,
Employment Income – Salaries Tax

Non-Hong Kong Employment (s.8(1A)):

- Extension of charge (s.8(1A)(a))
- All income derived from services rendered in HK including leave pay attributable to HK Services - Time based apportionment in practice
- Exemptions:
  - No Services rendered in Hong Kong
  - s.8(1A)(c) not applicable - not income of overseas service
- Services rendered in Hong Kong?
  - Services rendered in Hong Kong during visits not exceeding 60 days will not be taken into account (s.8(1B))

---

Employment Income – Salaries Tax

HK Employment?

Yes, Hong Kong Employment

Services in HK?

Yes

60 days exemption?

Yes

No Liability

No

Fully taxable

No

No Liability

No, Foreign Employment

Services in HK?

No

No Liability

No

Partly Liable

Yes

60 days exemption?

Yes

No Liability

No
Employment Income – Article 15 Income from employment

- Subject to the provisions of Articles 16 (Directors’ fees), Article 18 (Pensions), and Article 19 (Government service), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration may be taxed in that other State.
- Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first mentioned State if:
  - the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
  - the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
  - the remuneration is not borne by a PE which the employer has in the other State.

Employment Income – Article 15 Income from employment

- Article 15 only applicable to Non-HK Employment
- Tax exposure in Hong Kong when exceeding the days specified in the CDTA, which is usually 183 days in any twelve month period commencing or ending in the fiscal year concerned
  - Longer than 60 days in the Section 8(1A)
  - Not referring in the year of assessment
- Implications:
  - Hong Kong employment will be taxed according to domestic law irrespective the individual is a non-HK resident
  - Non-Hong Kong employment will have protection under the treaty
**Employment Income – Article 15 Income from employment**

- Non-resident (foreign employment) started working in HK on 1 October 2011 and finished on 30 September 2012

<table>
<thead>
<tr>
<th>Case</th>
<th>Y/A 2011/12</th>
<th>Y/A 2012/13</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>100</td>
<td>80</td>
<td>180</td>
</tr>
<tr>
<td>2</td>
<td>125</td>
<td>55</td>
<td>180</td>
</tr>
<tr>
<td>3</td>
<td>110</td>
<td>80</td>
<td>190</td>
</tr>
<tr>
<td>4</td>
<td>135</td>
<td>55</td>
<td>190</td>
</tr>
</tbody>
</table>

No Treaty Situation
- Case 1: Liable in both years
- Case 2: Only liable in Y/A 2011/12
- Case 3: Liable in both years
- Case 4: Only liable in Y/A 2011/12

From Treaty Country
- Case 1: No Liability in both years
- Case 2: No Liability in both years
- Case 3: Liable in both years
- Case 4: Only liable in Y/A 2011/12

**Office Income – Salaries Tax**

Income from Hong Kong Office
- fully taxable
- exemptions under s.8(1A) are applicable to employment but not to office
- services rendered outside Hong Kong is irrelevant

Income from foreign office
- not taxable - not within the scope of s.8(1)
Office Income – Article 16 Directors’ Fees

- Directors’ fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

- Implications: Only Income from HK office will be taxed in HK

The End

The information contained in this presentation is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PwC client service team or your other tax advisers. The materials contained in this presentation were assembled on 31 July 2012 and were based on the law enforceable and information available at that time.