

company being deregistered (Sec. 291AA(3)(b) of the *Companies Ordinance*). This is intended, presumably, to ensure that the Registrar of Companies does not deregister a company which owes taxes, thereby preventing the Commissioner from taking recovery action against that company.

To permit the Commissioner to issue such a notice, however, the IRO required amendment and, therefore Sec. 88B and Sch. 11 were introduced. Sec. 88B merely authorises the Commissioner to issue, on application, the notice envisaged by the Companies Ordinance on payment of the fee specified in Sch. 11. That fee is currently \$350, but can be changed by order of the Secretary for the Treasury.

## Chapter 11 ■ International Aspects of Hong Kong Taxation

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## 11.1 Introduction

This book is predominantly concerned with the law and practice regarding taxes imposed by the laws of Hong Kong. Hong Kong is not, however, isolated from the rest of the world in terms of foreign trade and investment. Accordingly, this chapter examines some international aspects of taxation to highlight various issues faced by overseas enterprises investing in Hong Kong and Hong Kong enterprises investing abroad.

In particular, this chapter looks at some common features of tax systems around the world and how these may give rise to double taxation in relation to cross border transactions and the means by which such double taxation may be avoided or mitigated. But cross border transactions or foreign investment can present tax planning opportunities and this chapter also discusses some anti-avoidance provisions commonly found in domestic tax legislation which aim to counter such tax planning opportunities. Having looked at these issues in general terms, the chapter then considers some of the common tax issues which arise in the context of investment into, and out of, Hong Kong.

The material covered in this chapter is often loosely referred to as "international tax." It is important to remember, however, that taxation is fundamentally a domestic issue as it is imposed by jurisdictions on the basis of their sovereign right to tax residents of, or economic activity occurring within, the jurisdiction. In other words, there are no true "international" taxes, notwithstanding the existence of DTAs between countries and moves to harmonise the tax systems of certain regions, most notably the European Union. As such, the term "international tax" really only refers to how a domestic tax system impacts on a transaction which has international elements. Nonetheless, the lack of consistency between domestic jurisdictions can bring about potentially onerous consequences for certain businesses or transactions and the role of a tax adviser in relation to such transactions is to understand why such consequences arise and advise on the means by which such consequences may be avoided or mitigated.

Except where specifically noted, the discussions in this chapter focus on corporate tax issues as this is the area of Hong Kong tax where international transactions have the greatest impact. The international aspects of Salaries Tax are, however, largely covered in Chapter 3. Property Tax, being a tax on income from land or buildings in Hong Kong has limited international aspects although, as with the other taxes, where it is incurred by a non-resident a credit for the tax may be granted in a foreign jurisdiction (see section 11.2.3).

Finally, this chapter should be seen as no more than an introduction to a complex topic which is worthy of a book in its own right. The space devoted to the material here is very limited and hence the discussions touch only very briefly on some of the main aspects of the topic.

## 11.2 General Principles of International Taxation

Although each jurisdiction's taxation system is unique, many share common features and elements and approach various matters in similar ways. Accordingly, when studying the taxation of international transactions it is important to have a broad appreciation of these common features. The paragraphs below look to some such features, the problems they can give rise to and the issues which they seek to address.

### 11.2.1 Residence and source as a basis for taxation

The imposition of taxes is generally seen as the sovereign right of a country or territory. In other words, each jurisdiction's right to impose and enforce tax laws, although potentially limited by its own constitution, is generally respected by other countries even if those tax laws are different to those imposed in other jurisdictions.

Nonetheless, traditionally one jurisdiction has not assisted another jurisdiction to enforce their tax laws. This has meant that in order to be effective and enforceable most jurisdictions have limited the basis of their tax laws to:

- persons (either individual or corporate) who are either nationals of, or resident in, the jurisdiction;
- economic activity occurring in the jurisdiction; and
- income or profits from property located in the jurisdiction.

This has led to the common position where jurisdictions seek to impose tax on a residence basis and/or a source basis.

A residence basis of taxation is where tax is imposed on the income or profits of a resident irrespective of from where such income or profits are derived (i.e. where they have their source). A resident for this purpose is as defined in the relevant legislation, but for an individual it is usually determined by the person's particular facts and circumstances focusing on physical presence, maintenance of a home, family and social ties, income and financial activities and, occasionally, citizenship. More specifically, the tests usually look at where the person's home and family are located

overlying that may be a test of physical presence to deem a person to be a resident where they spend a significant amount of time in a jurisdiction notwithstanding that under the general tests they may be considered resident elsewhere.

For a company, residence is usually determined in the first instance by the place of incorporation. Because, however, such a test is easy to avoid without restricting a company's right to carry on business in the jurisdiction, corporate residence may also be determined on the basis of the place of central management and control, or sometimes the place of effective management, of a company. Typically, a jurisdiction will deem as a resident any corporation incorporated in the jurisdiction, or incorporated elsewhere but centrally managed and controlled (or effectively managed) in the jurisdiction.

A source based system of taxation on the other hand is where a jurisdiction seeks to tax income or profits from a source in the jurisdiction, which would typically include amounts derived from a business carried on in the jurisdiction and amounts derived from property (including, but not necessarily limited to, real property, financial assets and intellectual property) located in the jurisdiction.

The combined effect of these two bases of taxation is that jurisdictions commonly seek to tax residents on their worldwide income (i.e. income derived from any jurisdiction) and non-residents on their income arising within the jurisdiction. There are, of course, many exceptions to this common basis of taxation. For example, Hong Kong essentially imposes tax only on a source basis and many jurisdictions which adopt a residence basis of taxation grant extensive exemptions in respect of income or profits which arise outside of the jurisdiction. Nonetheless, it is the prevalence of these bases of taxation which set the stage for double taxation to arise in international transactions.

### 11.2.2 Double taxation

One of the main issues in the taxation of international transactions is the potential for an amount of income or profit to fall to be taxed in two or more jurisdictions; this is known as international (or juridical) double taxation. As was discussed above, jurisdictions commonly tax residents on their worldwide income and non-residents on their income arising within the jurisdiction. This immediately gives rise to a risk of double taxation as one jurisdiction may seek to tax an amount on the basis that it is derived by a resident of the jurisdiction and another may seek to tax

the same amount on the basis that it has a source in the jurisdiction. Competing claims of this type can be referred to as residence-source conflicts and are the most common scenario under which international double taxation potentially arises.

International double taxation can, however, also potentially arise under other circumstances. For example, differences in the legislation determining the residence status of a person may mean that two jurisdictions each treat the same person as a resident; we will refer to this situation as a residence-residence conflict. Further, differences in rules governing the source of income or profits may mean that two or more jurisdictions each treat the same amount as having a source in their jurisdiction; we will refer to this as a source-source conflict.

It is also important to be aware that just as conflicts between domestic tax systems can give rise to double taxation, they can also give rise to the position where an amount of income or profit falls outside the charge to tax in any jurisdiction. Although this situation is undoubtedly less common, it nonetheless occurs and advisers need to be aware of the planning opportunities that such situations offer.

International double taxation is to be distinguished from economic double taxation which is the situation where the same profits are effectively taxed in the hands of two separate persons. This can arise where a company is taxed on its operating profits, but those profits are effectively taxed again in the hands of shareholders when the profits are distributed by way of a dividend. To avoid this, many jurisdictions exempt dividends from tax or operate dividend imputation systems where credits for corporate tax paid are attached to dividends. Economic double taxation can also occur where, for example, a transfer pricing adjustment (see section 11.2.7.1) is made in one jurisdiction but there is no corresponding adjustment in the other jurisdiction. It is important to note that economic double taxation can arise within a jurisdiction or across international borders and this presents difficulties in dealing with it on an international basis.

### 11.2.3 Relief from double taxation

Although the potential for double taxation in international investments or transactions is common, most jurisdictions accept that it should be mitigated or avoided as it potentially leads to distortions in investment decisions; this can in turn result in economic inefficiencies by diverting resources from where they would otherwise be most profitably employed.

Consequently, most jurisdictions make provision for some form of relief from double taxation. This relief can be granted on a unilateral basis through incorporation into domestic law, or a bilateral basis through entering into DTAs with other jurisdictions. Quite commonly, unilateral and bilateral relief in fact co-exist.

It is normal for unilateral double taxation relief to be granted by jurisdictions which tax their residents on worldwide income. International custom generally provides that this takes the form of the home jurisdiction (i.e. the jurisdiction of residence of the taxpayer) giving up, or modifying, its right to tax residents on income which has been subject to foreign tax in the source (or host) jurisdiction. There are a number of forms which this relief from double taxation can take, although the most common forms are the credit method and the exemption method. Under the credit method, the home jurisdiction grants a credit for tax suffered in the host jurisdiction, while under the exemption method foreign income which has suffered tax in the host jurisdiction is exempted from tax in the home jurisdiction. Nonetheless, there are other less common methods such as the deduction method under which host jurisdiction tax paid is allowed as a deduction in the home jurisdiction and the reduction method where foreign income which has suffered tax in the host jurisdiction is taxed at a reduced rate in the home jurisdiction.

As noted, under the credit method, a credit for the source (or host) jurisdiction tax is granted in the residence (or home) jurisdiction; in other words, the residence jurisdiction tax payable is reduced by the amount of the foreign tax suffered. The precise terms under which the tax credit is granted may vary between jurisdictions, although generally the amount of the credit is limited to the amount of tax payable in the residence jurisdiction on the relevant income. Although this concept is straightforward, issues can arise if the amount of foreign income is calculated differently in the source jurisdiction and residence jurisdiction. Typically such differences arise due to different approaches between the jurisdictions in determining the income attributed, and the expenses allocated, to the source jurisdiction. Similar issues can arise under the exemption method; that is, although it is accepted that foreign income subject to tax in the source jurisdiction is exempt in the residence jurisdiction, differences in the means of allocating income and expenses can mean that the amount of net foreign income for the purposes of the exemption in the residence jurisdiction may be different from the amount subject to tax in the source jurisdiction.

Whether a jurisdiction chooses to adopt the credit or the exemption

method (or indeed any other method) of double taxation relief is a matter of policy in the jurisdiction. Most jurisdictions to some extent adopt as an ideal the concept that the tax system should not distort investment decisions, although such a concept can be interpreted in different ways. Some jurisdictions adhere to a concept known as capital-export neutrality which suggests that a resident should face no difference from a tax perspective between investing in their home jurisdiction and abroad. Such a view tends to favour the adoption of the credit method in order that the home jurisdiction tax rate is suffered on all income (unless the host country tax rate is higher).

On the other hand, some jurisdictions favour the concept of capital-import neutrality which suggests that a resident investing abroad should not be disadvantaged by being subject to home jurisdiction tax on foreign earnings as this would put the resident in a less competitive position than a resident of the host jurisdiction. Adopting this view tends to lead to the adoption of the exemption method.

Although common, unilateral double taxation relief can only effectively address double taxation arising under residence-source conflicts, albeit such conflicts are the most common reason for potential international double taxation. Because residence-residence and source-source conflicts arise as a result of differing domestic provisions, they are difficult to resolve on a unilateral basis as they would require one jurisdiction to ignore its domestic law provisions. Instead, such conflicts can generally only be dealt with on a bilateral basis (i.e. through entering into DTAs), although it is important to note that such DTAs also address residence-source conflicts.

Economic double taxation, being an issue which can arise in an international context as well as a purely domestic context can also be dealt with on a unilateral basis. This is usually done by exempting dividends from tax or adopting a dividend imputation system. A dividend imputation system involves giving a credit to shareholders for corporate tax suffered, although this usually applies only in a domestic scenario (i.e. where the company and the shareholder are resident in the same jurisdiction). Nonetheless, some jurisdictions unilaterally allow credits for underlying foreign tax (i.e. foreign corporate tax suffered by a company resident abroad but paying dividends to a resident of the jurisdiction) in certain circumstances, although this tends to be more restricted than a domestic dividend imputation system. As discussed in section 11.2.6.9 below, however, such relief for underlying foreign tax is generally not

#### 11.2.4 Double taxation agreements — general

DTAs are bilateral agreements entered into between countries primarily to deal with the issue of double taxation. More than 2,000 such agreements are currently in existence. Although DTAs are individually negotiated, they are typically based on one of a number of model agreements, the most common of which is that promulgated by the Organisation for Economic Co-operation and Development (OECD). This is commonly referred to as the OECD Model. The OECD Model was first published in 1963, but has undergone significant revisions over the intervening years. It is now published in loose-leaf form so that any terms can be revised, with the unanimous agreement of OECD member states, without the need to publish a whole new version of the agreement. Although the OECD Model, as well as the various other model agreements, contain standard provisions, those provisions are intended only as a guide and when a DTA is negotiated, it is usual that variations to the standard terms are included.

The OECD Model is often considered to be quite restrictive regarding the rights of the source jurisdiction to tax amounts and, as a consequence, not favourable for developing countries which tend to be importers of capital and intellectual property. For this reason, the United Nations (UN) developed another model DTA which is intended to offer more benefits to developing economies by giving the source jurisdiction greater rights to tax amounts. Nonetheless, unless otherwise stated, in the remainder of this chapter discussions will centre on the OECD Model.

As noted, the principal purpose of a DTA is to avoid double taxation and this is achieved by modifying the rights of the respective jurisdictions to impose tax on specified types of income. In other words, they prevent a jurisdiction from taxing an amount, or permit it to tax the amount to a limited extent only.

As DTAs are international treaties between jurisdictions, and because they are essentially intended to modify the contracting states' rights regarding taxation, they generally over-ride domestic law. Care should, however, be taken in assuming that DTAs will always over-ride domestic law as a DTA is usually incorporated into a contracting state's domestic law through particular legislative provisions and such legislation can sometimes govern the interpretation of a particular term or clause in a DTA. Moreover, occasionally a contracting state will, subsequent to the implementation of a DTA, pass a domestic law which will affect the interpretation of existing DTAs.

DTAs are not subject to interpretation by international courts. As a result, there is no jurisprudence governing the interpretation of the terms of DTAs which can be applied in all jurisdictions. Rather, the parties to a DTA are generally required to work together to interpret a DTA in accordance with the customary international law as set out in the *Vienna Convention on the Law of Treaties*. Essentially, this requires that disputes be resolved in accordance with the mutual intentions of the parties when entering into the DTA. To assist in this process, the OECD publishes "commentaries" on the OECD Model. These commentaries, which are agreed by OECD member states, discuss the terms of the model agreement in some depth and contain examples of how the terms should be applied in various situations. The commentaries also, however, permit member states to express observations, or note reservations, about particular terms or interpretations of a provision of the model agreement. That is, a state may observe that it disagrees with a particular interpretation contained in a commentary, or may reserve its position on a term. By noting such observations, a state is putting existing and future DTA partners on notice that it will not agree to a particular interpretation. Similarly, by noting a reservation a state is putting future DTA partners on notice that it does not wish to include a particular term in its DTAs in the form contained in the model agreement.

Even where countries provide for unilateral double taxation relief, DTAs offer a number of benefits. This is because, as discussed above, not all instances of double taxation can be resolved on a unilateral basis. In particular, double taxation resulting from residence-residence and source-source conflicts cannot readily be addressed on a unilateral basis. Moreover, DTAs ensure a degree of consistency in rules between jurisdictions and also contain other terms governing taxation between the contracting states.

### 11.2.5 Structure of double taxation agreements

As noted above, every DTA is individually negotiated although they are generally based on a model and, therefore, have many features in common. Generally they are comprised of chapters, within which there are various articles. By way of example, the structure of the OECD Model is shown in Figure 11.1 below.

As can be seen, the OECD Model begins by defining the scope of the agreement. This essentially involves defining the persons covered, which are residents of one or both of the contracting states, and the taxes

Figure 11.1 Structure of OECD Model

Chapter	Articles	Topic	Examples
1	1, 2	Scope	Persons covered Taxes covered
2	3-5	Definitions	General definitions Residence Permanent establishment
3, 4	6-22	Taxation of income and capital	Dividends, interest, employment, capital gains, business profits, etc.
5	23	Double tax relief	Credit method, exemption method
6	24-29	Special provisions	Non-discrimination Mutual agreement procedure Exchange of information
	30-31	Final provisions	Entry into force, termination

covered which are generally existing taxes and future taxes of a similar nature.

The next chapter of the OECD Model deals with definitions. The relevant articles deal with a limited number of specific terms, most notably the terms "resident" and "permanent establishment." Some terms are, however, defined elsewhere in the DTA (i.e. in the article where the term is used), or may be clarified in the commentaries on the relevant article. The article containing general definitions also provides that where a term is not defined in the DTA, it is to be interpreted in accordance with the domestic law of the jurisdiction of the tax to which the DTA is being applied, although only where the context does not require otherwise. Accordingly, where a term is not defined in a DTA and the context is such that referring to the domestic law definition is inappropriate, it may be appropriate to look to definitions or jurisprudence of another jurisdiction.

Chapters 3 and 4 of the OECD Model contain the more important operative provisions under which the contracting states' rights to tax amounts, and the extent to which they may be taxed, are set out. This is followed by Chapter 5, which comprises the provision under which relief for double taxation is to be provided.

The remainder of the document deals with special provisions including mutual agreement procedures, which are essentially the means of resolving disputes, exchange of information, non-discrimination and administrative provisions regarding entry into force and termination.