



Hong Kong Tax Newsflash

Impact of recent economic substance laws from a Hong Kong perspective

With recent introductions of economic substance laws in the British Virgin Islands (BVI) and the Cayman Islands (Caymans), Chinese businesses may look more frequently to Hong Kong as a jurisdiction in which to establish substantive holding and investment structures.

Background

In response to the action 5 of the OECD BEPS project regarding harmful tax practices and the EU list of non-cooperative tax jurisdictions, the BVI and the Caymans have introduced legislation requiring, among other things, certain entities in their respective jurisdictions to undertake substantial business activities and abide by specific compliance measures to satisfy economic substance requirements.

In the BVI, on 23 April 2019, the International Tax Authority released a draft version of the [Economic Substance Code](#) (Code), which provides additional rules and guidance to assist with the interpretation of the Economic Substance (Companies and Limited Partnerships) Act of 2018 enacted in December 2018. The Code would provide clarifications regarding the implementation of the economic substance rules, including additional guidance on the requirements for non-resident entities, activity definitions, considerations for applying the substance requirements and relevant timelines.

Similarly, the Caymans introduced the International Tax Co-operation (Economic Substance) Law, 2018, effective as of 1 January 2019, which details the entities and activities that are required to satisfy the economic substance test and to submit annual reports indicating, among other things, the location of management and control of the relevant entity and the location of core income generating activities. Various

compliance requirements and corresponding penalties also are set forth in the legislation.

Both the BVI and the Caymans apply economic substance requirements generally to companies formed within their respective jurisdictions unless such companies are tax resident in another jurisdiction, and to companies that are engaged in specific activities within their respective jurisdictions. Many Chinese enterprises have holding companies and investment structures in the BVI and the Caymans, and potentially could be affected by the new economic substance laws. Additional expenditures and geographical constraints may create challenges for Chinese enterprises attempting to comply with the rules.

Hong Kong as a jurisdiction for holding and investment

Apart from the need to comply with the economic substance rules in the BVI and the Caymans, a Chinese enterprise may consider other options, including relocation of offshore holding and investment structures, internal group restructuring and business outsourcing arrangements. Furthermore, under the BVI and the Caymans economic substance laws, BVI and Cayman entities that are tax resident in other jurisdictions (and that are not engaged in specific activities within their respective jurisdictions) are not subject to their economic substance legislation. Therefore, enterprises may wish to consider having such entities establish economic substance in another jurisdiction to become tax resident in that jurisdiction, such as Hong Kong.

According to the World Bank's Doing Business 2019, Hong Kong is ranked fourth globally on the list of easiest places to do business. Given its strategic geographical location, important transportation hub and talented workforce, Hong Kong has long been considered Asia's international financial and trade center, as well as being a major platform for international investment and financing. Moreover, Hong Kong provides clear and standardized rules for foreign entities conducting business within its jurisdiction, and it has a competitive general profits tax rate of 16.5% (with an 8.25% rate applying on the first HKD 2 million of assessable profits). The tax system generally is considered straightforward and includes tax measures such as a 50% tax concession for certain trades and businesses (e.g. corporate treasury center, aircraft leasing, etc.), and an enhanced tax deduction regime for qualifying research and development activities.

Hong Kong has been removed from the EU list of non-cooperative jurisdictions and has taken steps to comply with the OECD BEPS framework. Furthermore, Hong Kong has entered into double tax agreements with approximately 40 jurisdictions, so qualifying entities could enjoy tax benefits and protections under this treaty network. Under the China-Hong Kong double tax arrangement, a qualified Hong Kong entity receiving dividends, interest and royalties from China could enjoy the preferential Chinese withholding income tax rates.

Strategically located at the gateway to Mainland China, Hong Kong is often the first choice for Chinese enterprises investing overseas. Under the framework of China's Belt and Road Initiative and the Guangdong-Hong Kong-Macao Greater Bay

Area development, the Hong Kong government has implemented initiatives in recent years to bring in investments from China and elsewhere. In addition, many Chinese enterprises use BVI and Cayman entities within their group structures for listing in Hong Kong or already have such entities engaged in investment, trading, financing, and/or research and development in Hong Kong. As such, it may be feasible for Chinese enterprises to strengthen their operations in Hong Kong for these BVI and Cayman entities to become tax resident in Hong Kong.

Obtaining tax residence in Hong Kong

The BVI and Cayman governments have not indicated what will be required as proof of tax residence in another jurisdiction. Although proof could include business registration certificates, tax filing records, tax assessments or tax identification numbers, a Certificate of Resident Status (CoR) may be accepted. A CoR is issued by Hong Kong's Inland Revenue Department (IRD) to domestic or foreign entities that require proof of residence status for purposes of claiming tax benefits under tax treaties and arrangements. A key factor in obtaining a CoR is establishing that the applicant has commercial substance in Hong Kong, which could make the CoR particularly valuable to the BVI and Cayman governments in accepting tax residence in Hong Kong.

Hong Kong's Inland Revenue Department (IRD) will consider many factors when making a tax residence assessment and applicants are required to provide supporting documentation with their applications. The factors taken into consideration include the location of the entity's central management and control, the commercial substance of business operations, whether the entity has a physical office in Hong Kong, the place of residence of directors, senior management and staff, how the directors and senior management manage the entity and the nature of the business in Hong Kong.

To this end, establishing commercial substance in Hong Kong by BVI and Cayman entities will facilitate obtaining a CoR, and, if the BVI and Cayman governments accept the CoR as proof of residency in Hong Kong, such entities presumably would not be subject to the economic substance laws of those jurisdictions.

Compliance obligations in Hong Kong

A foreign entity should register with the Hong Kong Companies Registry as a non-Hong Kong company if it has established a place of business in Hong Kong under the Companies Ordinance. The entity also should apply for business registration within one month from the date of commencement of business according to the Business Registration Ordinance. In addition, annual renewals of the business registration certificate and annual return filings are required to be completed on a timely basis. The entity may incur fines and credit risk for failure to comply with these obligations.

Foreign entities resident in Hong Kong generally are required to submit an annual tax return. Nevertheless, if the entity has incurred tax losses for several years, the IRD will not issue a tax return, so filing will not be required unless the entity has

derived assessable profits during that year of assessment. In terms of tax compliance, taxpayers must keep relevant records for a period of not less than seven years for tax purposes. If the BVI and Cayman entities have derived profits in Hong Kong in past years (i.e. the entities carrying on a trade, profession or business in Hong Kong derived profits from Hong Kong from such trade, profession or business), the IRD is empowered to review and raise assessment on the entities for up to six years even if there was no business registration in Hong Kong at that time.

As from 1 April 2018, Hong Kong has implemented the relevant provisions on transfer pricing in line with the requirements of actions 8-10 of the OECD BEPS project, in particular, the three-tiered transfer pricing documentation requirements (i.e. master file, local file and country-by-country report). In addition, Hong Kong taxpayers are required to disclose related party information in the profits tax return, and for transactions with non-resident associated persons, the jurisdictions where associated persons reside must be provided, with certain jurisdictions (including the BVI and Caymans) listed separately.

With regard employees, entities are required to submit an annual return to declare the status of any Hong Kong employees.

Comments

The introduction of the economic substance laws results in a further tightening of international tax controls, and the offshore structures of Chinese enterprises will inevitably be affected. In view of the changes in the BVI and the Caymans, Chinese enterprises should assess their holding and investment structures in these jurisdictions to understand the economic substance requirements and the relevant disclosures in future reporting. If Hong Kong tax residency is chosen for any BVI or Cayman entities, a further assessment from a Hong Kong perspective should occur with respect to existing investment and financing structures, as well as a function and risk analysis, and possibly preparation of a CoR application. In all cases, compliance obligations should be taken into account.

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