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Authors:

Hong Kong
Patrick Yip
Tax Partner
Tel: +852 2852 1618
Email: patyip@deloitte.com.hk

Finsen Chan
Senior Tax Manager
Tel: +852 2852 5612
Email: finchan@deloitte.com.hk

Impact of BEPS Action 6 on Source-Based Tax Jurisdictions: the Case of Hong Kong

On October 5, 2015, the Organisation for Economic Cooperation and Development (OECD) released the final report on action 6 of the base erosion and profit shifting (BEPS) project, which addresses tax treaty abuse. The report, entitled *Preventing the Granting of Treaty Benefits in* Inappropriate Circumstances, contains provisions for the OECD model tax treaty and commentary to the model to deal with the inappropriate granting of treaty benefits and other potential treaty abuse situations.

This article looks at the potential impact of the final report on action 6 on Hong Kong once the recommended measures are implemented by various countries around the world.

I. Relevance to Hong Kong

In November 2013,[1] the Hong Kong Government undertook to embark on studies and engage local stakeholders for appropriate follow-up actions in response to the 15 BEPS actions. In February 2015,[2] the government announced that it would review the Hong Kong tax regime, including the application of existing taxation principles, the provision of tax concessions and the enforcement of an anti-avoidance mechanism, and assess the extent to which Hong Kong could meet the emerging international expectations and standards.

With respect to action 6, the Hong Kong Inland Revenue Department (IRD) envisaged that, in future negotiations, countries that have signed a double taxation agreement (DTA) with Hong Kong will likely request that Hong Kong incorporate the proposed changes in a relevant DTA to prevent treaty abuse, and in particular, treaty shopping.

[1] Press release issued by the Information Services Department press on November 20, 2013 (LCQ13: Prevention of tax base erosion and profit shifting).
[2] The Hong Kong Institute of Certified Public Accountants (HKICPA) Tax Bulletin, November 2015, refers to the 2015 annual meeting between the IRD and the HKICPA.

The OECD final report on action 6 recommends a three-pronged approach to address treaty shopping:[3]

1) a clear statement in the title and preamble of a DTA that the contracting parties intend to avoid creating opportunities for nontaxation or reduced taxation through tax evasion or avoidance;
2) the inclusion of a specific anti-abuse rule, known as a limitation-on-benefits (LOB) provision; and
3) the inclusion of a general anti-abuse rule based on the principal purpose of a transaction or arrangement (the "principal purpose test" or "PPT rule") to tackle transactions or arrangements that otherwise may fall outside the reach of the LOB rule.

Specifically, the following issues may be relevant to Hong Kong under this approach:

- A taxpayer from a country that makes an offshore claim for Hong Kong tax purposes may be exposed to a "nontaxation" challenge if the Hong Kong offshore income is not otherwise taxable in the DTA country.
- A Hong Kong company without many business operations in Hong Kong may no longer be eligible for benefits under Hong Kong DTAs given the LOB rule even if that company is by definition a Hong Kong tax resident for treaty purposes.
- A transaction that otherwise would be eligible for benefits under a Hong Kong DTA may trigger a challenge by the IRD and the invocation of anti-avoidance principles resulting in the denial of benefits under the DTA.

II. Discussion

A. Title and Preamble to Double Taxation Agreement

As noted above, the final report on action 6 includes revisions to the title and preamble of the OECD model treaty to clarify that the intention is to eliminate double taxation without creating opportunities for nontaxation or reduced taxation through tax evasion and avoidance, including through treaty shopping arrangements.[4]

Hong Kong operates a territorial tax system, under which only profits that have a source in Hong Kong are taxable in Hong Kong—profits from a source outside Hong Kong are not taxable in Hong Kong. To determine the source of profits, Hong Kong has long relied on the "operations test," which involves identifying the activities that are most important in generating the profits and the place where these activities are carried out. In essence, under the operations test, the approach is to determine where the operations from which the profits in substance arose took place.

It is possible that certain profits from cross-border operations are sourced offshore and thus nontaxable to a Hong Kong tax resident, while the same profits also are nontaxable in a relevant DTA country by operation of the provisions in a relevant DTA (e.g., the activities do not exceed the threshold for a permanent establishment (PE)[5] under the relevant DTA). It is not clear whether, in the context of the final report on action 6, this type of transaction would be regarded as a "double nontaxation" transaction, thus making treaty benefits unavailable. If double nontaxation would arise, would this mean that the Hong Kong resident would be deemed to have a taxable presence in the other treaty country and have to pay tax to that other country (Approach 1)?

The following somewhat odd situation could potentially arise if Approach 1 is adopted:

- The Hong Kong resident is not subject to tax in Hong Kong (due to an offshore claim) or in a foreign country (because it does not have a PE in that other country).
- The Hong Kong resident is deemed to have a PE in the DTA partner country and is required to pay tax to that country.
- The IRD subsequently denies the Hong Kong resident's offshore claim and requires the payment of Hong Kong profits tax.

[3] Other recommendations in the final report on action 6, such as tax policy considerations and measures to address specific situations such as the splitting-up of contracts, dividend transfer transactions, etc. are not discussed in this article.

[4] The revised version reads as follows:
"TITLE OF THE CONVENTION
Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance
PREAMBLE TO THE CONVENTION
(State A) and (State B),
Desiring to further develop their economic relationship and to enhance their cooperation in tax matters,
Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States."

[5] Section A(1)(b)(vii) of the final report contains a specific anti-abuse rule for PEs situated in third states.

Thus, in effect, Approach 1 would not have been applicable in the first place (i.e., there is no double nontaxation). Would this mean that the Hong Kong resident could request a tax refund from the DTA partner country?

To take this argument a step further, would this result encourage the Hong Kong Government to tighten its rules on offshore claims so that the Hong Kong resident would have to pay some tax to Hong Kong that otherwise may have been paid to the other treaty country?

Alternatively, if a Hong Kong resident realizes that it will have to pay tax to at least one jurisdiction under BEPS, it may simply file a profits tax return with the IRD without making an offshore claim, given that the result of lodging an offshore profits claim is uncertain, the additional work required to make the offshore claim given BEPS may no longer be justified, and Hong Kong's corporate tax rate of 16.5% is considered low compared to the rate in many DTA countries.

Currently, in certain cases, an item of income that is not subject to tax either in Hong Kong or in the DTA country may be deemed to be income subject to tax in Hong Kong. For example, under Section 23C(2A)-(2D) of the Hong Kong Inland Revenue Ordinance (IRO), certain income from the operation of international aircraft (pursuant to Hong Kong's DTAs and air services income agreements) would be taxable in Hong Kong if the income is accrued to a Hong Kong tax resident and the income is not taxed in the DTA country or in Hong Kong.

Perhaps Hong Kong may consider this framework as a possible mechanism to deal with double nontaxation issues in cases where a Hong Kong resident receives income that is not taxable in the DTA partner country (and is not otherwise taxable in Hong Kong). Such income would be taxable in Hong Kong (Approach 2). However, nothing would preclude the DTA partner country from adopting a similar mechanism under its domestic law, and thereby creating another double taxation issue.

B. Limitation on Benefits Provision

The final report on action 6 proposes the addition of an LOB in tax treaties to prevent treaty shopping, but that additional work is needed with respect to the LOB. A final version of the LOB rule is anticipated in 2016.

As currently proposed, the LOB would have the following features:

- a recognition that governments, publicly-traded companies, financial institutions and certain widely held entities are unlikely to be established for treaty shopping purposes;
- individuals generally are entitled to DTA benefits if they meet the residence requirements under the DTA; and
- an "active conduct of a business" test for companies that are not widely held.

The active conduct of business test may have a significant impact due to its potentially wide coverage. The commentary to the LOB rule (paragraph 47) provides as follows:

> An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting (such as officers or employees of a company) conduct substantial managerial and operational activities.

However, headquarters operations are not regarded as an active conduct of a business, according to paragraph 48 of the commentary, which states in part:

> Since a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in the active conduct of a business . . . .

Without the LOB rule, a resident with only headquarters operations generally would be able to enjoy DTA benefits provided it is not a conduit passing its income through to a third party[6] (i.e., it must be the beneficial owner of the income). As a result of the LOB provision (and the active conduct of a business test), companies would need to carry out active businesses other than merely headquarters operations.

The impact of the LOB rule is far-reaching for Hong Kong. The time when a Hong Kong company without substantial business operations in Hong Kong for just investment holding purposes is eligible for treaty benefits

[6] On beneficial ownership, see Indofood International Finance Ltd. v. JPMorgan Chase Bank N.A., London Branch, A3/2005/2497; Prevost Car Inc. v. Regina, 2009 FCA 57, 2009 DTC 5053; and Velcro Canada Inc, v Regina, 2012 TCC 57.

may soon end given this LOB rule, which may affect Hong Kong's position as an international gateway for inbound and outbound investments vis-a-vis China and other countries in the Asia Pacific region.

In fact, the IRD has already changed its approach to approving a Certificate of Resident Status (CoR) for treaty purposes, apparently responding to the BEPS developments and possibly the concerns of its DTA partners. The IRD released new CoR forms in February 2015 that require more comprehensive information on the applicant than previously was required. During the 2015 annual meeting with the Hong Kong Institute of Certified Public Accountants held on February 6, 2015, the IRD stated that, when determining whether to issue a tax resident certificate to a company (regardless of whether the company is incorporated in Hong Kong or overseas), the IRD will also look at whether the applicant meets any additional requirements under the relevant DTA (such as being the beneficial owner and whether any abuse of the DTA is involved), in addition to meeting the definition of tax resident. The IRD will refuse to issue a CoR to a "paper" company incorporated in Hong Kong merely to obtain treaty benefits. In essence, the IRD has tightened its vetting process by requiring an applicant to have commercial substance in Hong Kong for the purposes of determining whether the company is managed or controlled in Hong Kong.The BEPS project also may have an impact on Hong Kong's newly enacted offshore private equity fund exemption. Following the enactment of the Inland Revenue (Amendment) (No. 2) Ordinance 2015 on July 16, 2015, the profits tax exemption granted to Hong Kong offshore funds was extended to certain nonresident private equity transactions[7] that do not have Hong Kong ties or connections exceeding a certain threshold.

Under this tax exemption regime, a private equity fund may conduct only specified transactions, (i.e., securities transactions in a portfolio company or a special purpose vehicle (SPV), where the SPV would have to be established solely for the purpose of holding (directly or indirectly) or administering one or more portfolio companies) and may not carry on any other business in Hong Kong. Given the restriction on an SPV's activities, an SPV may only carry out a headquarters operation, which, as mentioned above, may not be considered an active conduct of a business for purposes of the LOB rule in action 6. Accordingly, if the DTA between Hong Kong (where an SPV is a tax resident) and another country (where a portfolio company is a tax resident) contains the newly recommended LOB rule, the SPV, by definition, will not be able to enjoy benefits under the DTA (e.g., reduced withholding tax rates on dividends and capital gains). The Hong Kong Government may wish to address the potential effects of the LOB provision by expanding the scope of allowable activities of an SPV as soon as possible.

C. Principal Purpose Test

The final report on action 6 contains a general anti-abuse rule based on the principal purposes of transactions or arrangements (the "principal purpose test" or PPT rule) addressing transactions or arrangements that may otherwise fall outside the reach of the LOB rule.

The final report states as follows:

> Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

This provision allows countries that do not have domestic laws to address cases of the improper use of treaties and confirms the application of this principle for countries that already have domestic laws to address the situation.

Similar to Hong Kong's domestic general anti-avoidance tax rules,[8] the PPT rule will disallow a DTA benefit if one of the principal purposes of an arrangement or transaction is to obtain DTA benefits (meaning that the relevant income would be subject to the domestic tax rules), and it tackles transactions that otherwise may fall outside the ambit of the LOB rule (e.g., a listed company could satisfy the LOB rule, but may fail the PPT rule).

Without the PPT rule, it is doubtful that Hong Kong's domestic anti-avoidance rule would apply to DTAs since DTAs generally override domestic law. Some of Hong Kong's DTAs contain a "miscellaneous" article to address this situation (e.g., Article 27 of the Hong Kong–Kuwait DTA, which provides that "Nothing in this Agreement shall prejudice the right of each Contracting Party to apply its domestic laws and measures concerning tax avoidance, whether or not described as such.")

[7] See Deloitte's Tax Analysis of June 13, 2014, "Proposal to Extend Hong Kong's offshore fund exemption: Step in the right direction" and May 12, 2015, "Update on proposed Hong Kong profits tax exemption on offshore private equity funds."

[8] Sections 61 and 61A of the IRO are general anti-avoidance provisions. Section 61 targets artificial or fictitious transactions with the effect of tax avoidance, and Section 61A combats arrangements with the sole or dominant purpose of obtaining a tax benefit.

The PPT rule will provide clarity to Hong Kong that the domestic anti-avoidance rule could operate at the DTA level.

III. Conclusion

The three-pronged approach under the BEPS action 6 report is generally considered a positive step in tackling treaty abuse in cross-border transactions and arrangements. However, some of the provisions require more clarification, especially with respect to their effect on source-based tax jurisdictions, such as Hong Kong. Without these clarifications, Hong Kong's position as a prominent international center may be diminished and it may miss out on tax revenue collection vis-a-vis other taxing authorities.

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Beijing
Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 1326
Email: andzhu@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Shenzhen
Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

Chongqing
Frank Tang
Partner
Tel: +86 23 6310 6206
Fax: +86 23 6310 6170
Email: ftang@deloitte.com.cn

Jinan
Beth Jiang
Director
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@deloitte.com.cn

Suzhou
Frank Xu / Maria Liang
Partner
Tel: +86 512 6289 1318 / 1328
Fax: +86 512 6762 3338
Email: frakxu@deloitte.com.cn
mliang@deloitte.com.cn

Dalian
Bill Bai
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: bilbai@deloitte.com.cn

Macau
Raymond Tang
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: raytang@deloitte.com.hk

Tianjin
Jason Su
Partner
Tel: +86 22 2320 6680
Fax: +86 22 2320 6699
Email: jassu@deloitte.com.cn

Guangzhou
Victor Li
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: vicli@deloitte.com.cn

Nanjing
Frank Xu
Partner
Tel: +86 25 5791 5208
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn

Wuhan
Justin Zhu
Partner
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032
Email: juszhu@deloitte.com.cn

Hangzhou
Qiang Lu
Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn

Shanghai
Eunice Kuo
Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@deloitte.com.cn

Xiamen
Jim Chung
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: jichung@deloitte.com.cn

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National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader
Leonard Khaw
Partner
Tel: +86 21 6141 1498
Fax: +86 21 6335 0003
Email: lkhaw@deloitte.com.cn

Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Southern China (Hong Kong)
Davy Yun
Partner
Tel: +852 2852 6538
Fax: +852 2520 6205
Email: dyun@deloitte.com.hk

Southern China (Mainland/Macau)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Eastern China
Kevin Zhu
Director
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

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