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Tax Newsflash

Hong Kong Tax News:
Hong Kong-India tax treaty signed

The much anticipated Hong Kong-India Comprehensive Double Tax Agreement (the "Treaty") was signed on 19 March 2018 and will enter into force after the completion of ratification procedures by both sides.

The Treaty is largely based on the OECD model and contains key Base Erosion and Profit Shifting features such as an extended definition of permanent establishment and the inclusion of the principal purpose test ("PPT") clause. The PPT clause applies to the overall Treaty as well as specific types of income namely, Article 10 (Dividends), Article 11 (Interest), Article 12 (Royalties), Article 13 (Technical Fees) and Article 14 (Capital Gains).

The Treaty has been highly anticipated amid speculation on the allocation of taxing rights of capital gains between Hong Kong and India, with hopes that Hong Kong might be on par with or even become a favourable alternative to Mauritius and Singapore for accessing India since the removal of full capital gains exemptions from both treaties in 2016[1]. However, this does not appear to be the case, as other than with respect to ships and aircraft, the capital gains article provides no significant protection to Hong Kong residents. Accordingly, capital gains arising from the disposal of shares, bonds, derivatives and immovable property will not be protected from Indian capital gains tax, nor will gains in respect of indirect transfers.

<u>Favourable changes</u>

Withholding tax ("WHT") on interest received from India by a Hong Kong resident taxpayer who is also the beneficial owner of the interest will be capped at 10%, as opposed to the general non-treaty rate of 5%/20%/40% plus applicable surcharge and cess.

Profits derived by Hong Kong from the operation of aircraft in international traffic will only be taxed in Hong Kong.

Profits derived by Hong Kong resident taxpayers from the operation of ships in international traffic where such profits are subject to tax in India will receive a 50% reduction in Indian tax.

<u>Areas of no significant change</u>

Dividend WHT is capped at 5% under the Treaty, however neither Hong Kong nor India currently imposes dividend WHT. India does impose dividend distribution tax ("DDT") at the rate of 15%[2], which is not reduced under the Treaty. Therefore, the dividend paying company in India will still be subject to DDT on the aggregate dividend declared, distributed or paid.

WHT on royalties and technical fees are capped at 10%, whereas the non-treaty rate is charged at 10% plus applicable surcharge and cess. As such, it appears that the treaty rate is slightly more favourable as the Treaty provides relief from surcharge and cess.

The Treaty contains anti-abuse clauses on payments of interest, royalties and technical fees where treaty relief is only provided up to the arm's length amount. Accordingly, any amount in excess will be taxed accordingly under the respective domestic tax laws.

<u>Foreign tax credits</u>

As Hong Kong does not provide unilateral tax credit the introduction of any new treaty opens the door to the possibility of foreign tax credits in Hong Kong. Given Hong Kong's territorial system, the scenarios where foreign tax credits can be utilized are relatively narrow. However, of importance will be the ability to claim foreign tax credits in respect of interest WHT charged in India where the Hong Kong taxpayer is assessed under the operations test in Hong Kong.

A question remains as to whether the Inland Revenue Department will allow foreign tax credit on items which are taxed as capital gains in India and for which India provides no relief as a result of the Article 14 (Capital Gains) of the Treaty, but are regarded as revenue income of the Hong Kong recipient and which the Inland Revenue Department may argue should not be taxed by India as a result of Article 7 (Business Profits). Given Hong Kong's territorial tax regime such scenarios may not be common, but could arise for example in respect of frequent 'over-the-counter' transactions negotiated and executed in Hong Kong.

[1] Subject to grandfathering arrangements.
[2] The DDT payable is required to be grossed up and the effective rate is 20.3576%, including a 12% surcharge and a 3% education cess.

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