Canada
International Tax

Contacts:

National Leader - International Tax
Etienne Bruson
604-640-3175

Hong Kong
Chris Roberge
852-28525627

Atlantic
Brian Brophy
709-758-5234

Quebec
François Chagnon
514-393-7073

Tan Ong
514-393-5529

Ontario
Mark Noonan
613-751-6688

Tony Maddalena
905-315-5734

Toronto
Dennis Domazet
416-601-6449

Sandra Slaats
416-643-8227

Alberta
Andrew McBride
403-503-1497

Charles Evans
780-421-3884

British Columbia
Brad Gordica
604-640-3344

New York
Alex Smith
212-436-7949

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Hong Kong and Canada sign income tax agreement

November 20, 2012

Canada and the Hong Kong Special Administrative Region of the People's Republic of China signed an income tax agreement on November 11, 2012 (the agreement). This is Hong Kong's 26th agreement. Canada currently has 90 treaties in force and has signed a number of others. The agreement will enter into force upon the exchange of instruments of ratification.

Negotiation of the agreement was initiated in June 2011 and has been highly anticipated by communities in both Canada and Hong Kong. Its swift conclusion and the visit by The Honourable Mr. Stephen Harper, Canada's Prime Minister, to witness the signing ceremony signify the importance being placed on further strengthening the relationship between the two jurisdictions. Closer economic cooperation and the promotion of greater synergies between the two jurisdictions are anticipated. The agreement, in conjunction with domestic laws, offers tax benefits that are generally more attractive than benefits in Canada's treaties with its other major Asian trading partners such as China, India, Japan, Korea and Singapore. This should further Hong Kong's objective of being the gateway between Canada and the Asia Pacific region, as well as Canada's objective of fostering trade between Canada and the Asia Pacific region. As per David Nesbitt, Executive Director of the Canadian Chamber of Commerce in Hong Kong,

> "The new agreement has a significant number of positives for Canadians in Hong Kong. Many Canadians working in the city have strong ties back to Canada. As well, investors in Hong Kong may have avoided certain Canadian equities, due to withholding tax on dividends: this tax is reduced in certain circumstances to just 5%, and will increase interest in Canadian markets. Any new tax reduction effort between two countries definitely leads to increased investment from both sides".

Key features

A key aspect of the signing of the agreement for Canadian companies with Hong Kong subsidiaries is the opportunity for such subsidiaries to earn “exempt surplus” in respect of their active business earnings. Active business income earned in a country with which Canada has an income tax treaty or agreement is included in exempt surplus and can be repatriated free of additional Canadian tax. Once the agreement is ratified, a foreign affiliate resident in Hong Kong will be able to earn exempt surplus rather than taxable surplus retroactively beginning with its taxation year that includes November 11, 2012.

Generally speaking, the agreement is in line with the Model Tax Convention on Income and on Capital developed by the Organisation for Economic Co-operation and Development (OECD model). Key features of the treaty include:

- *Dividends* – reduction of Canadian withholding tax to 5%, where the beneficial owner is a corporation that controls directly or indirectly 10% of the voting shares. There is no dividend withholding tax in Hong Kong.
- *Interest* – reduction of Canadian withholding tax to 10% for non-arm's length interest. The withholding tax rate for arms' length interest is generally 0% (which corresponds to Canadian domestic tax legislation). There is no withholding tax on interest in Hong Kong.
- *Royalties* – reduction of Canadian withholding tax to 10%. The Hong Kong domestic rate of 4.95% should still apply to royalties paid to Canadian residents as it is lower than the rate of 10% in the agreement.

Canadian investors will benefit from Hong Kong's expanding network of tax agreements, which includes a favourable arrangement with China. The agreement may also increase the attractiveness of Hong Kong as a holding company location for investments in Canada, as compared to other jurisdictions.

A comparison of various treaty and domestic withholding tax rates is set out below:

	Canadian domestic	**Hong Kong domestic**	**Canada-Hong Kong agreement**	**Canada-China treaty**	**Canada–Singapore treaty**
Dividends	25%	0%	**5%**[1]	10%[2]	15%
Interest	25/0%	0%	**10%**	10%	15%
Royalties	25%	4.95%[3]	**10%**	10%	15%

1 The dividend withholding tax rate of 5% under the agreement applies if the beneficial owner is a company that controls directly or indirectly at least 10% of the voting power in the company paying the dividends.

2 The dividend withholding tax rate of 10% under the Canada-China treaty applies if the beneficial owner is a company that owns at least 10% of the voting stock of the company paying the dividends.

3 The 4.95% rate applies provided that a) the royalty is not paid to a related party, or b) if paid to a related party, the licensed intellectual property has never been owned in whole or in part by a person carrying on business in Hong Kong.

With regard to the taxation rights for capital gains derived from the disposal of shares in a company resident in the other jurisdiction, the agreement generally follows the OECD model and only allows the jurisdiction in which the alienator is resident to tax these capital gains. However, gains derived from the disposition of immovable property can be taxed in the other jurisdiction, including gains derived from the disposal of shares in a company that derives more than 50% of its value, directly or indirectly, from immovable property situated in the other jurisdiction. Unlike treaties concluded by Canada with certain countries such as Luxembourg and the Netherlands, there is no exception provided for situations where the value of the shares is derived principally from Canadian immovable property in which the business of the company is carried on.

Other notable provisions

Anti-abuse and limitation of relief measures

Following what appears to be a general trend in agreements/treaties signed by Hong Kong and Canada, (for Hong Kong, these include agreements signed with Indonesia, the Netherlands and the United Kingdom; for Canada, these include treaties signed with Colombia, New Zealand, Poland, etc.), the agreement contains anti-treaty shopping measures that seek to deny benefits under the dividend, interest and royalty articles for taxpayers where "one of the main purposes" in structuring a particular transaction is to obtain benefits under the relevant article.

Further, article 26(2)(b) of the agreement enables either jurisdiction to apply the "provisions of its law which are designed to prevent tax avoidance, including measures relating to thin capitalization". This provision presents an overarching curb on potential abuse of the agreement by broadly allowing either jurisdiction to apply its domestic laws in counteracting potential abusive transactions involving the agreement.

In addition, article 26(4) contains a provision that is not commonly seen in Hong Kong's or Canada's agreements/treaties. It states:

> "Where under any provision of this Agreement any income is relieved from tax in a Party and, under the law in force in the other Party a person, in respect of that income, is subject to tax by reference to the amount thereof that is remitted to or received in that other Party and not by reference to the full amount thereof, then the relief to be allowed under this Agreement in the first-mentioned Party shall apply only to so much of the income as is taxed in the other Party."

Broadly speaking, the provision seeks to limit benefits to amounts that are remitted to a partner jurisdiction where that jurisdiction only taxes such income on a remittance basis under its domestic tax law. Neither Canada nor Hong Kong taxes income on a remittance basis and therefore this provision should have no current application.

Exchange of information

Critical to the conclusion of the agreement were the exchange of information article and the related protocol. The agreement specifically provides that information communicated will be treated as secret and that it can be used only for the purposes provided for in the agreement. In addition, a protocol to the agreement states that it is understood that

- the agreement does not require the exchange of information on an automatic or spontaneous basis;
- information exchanged shall not be disclosed to any third jurisdiction for any purpose; and
- a party may only request information relating to taxable periods for which the agreement has effect for the party.

While the adoption of the 2004 version of the OECD model standard exchange of information article has enabled Hong Kong to negotiate and sign many agreements since 2010, the Hong Kong Inland Revenue Department had also issued Departmental Interpretation and Practice Notes No. 47 (DIPN 47) to assuage taxpayers' concerns about their privacy rights. DIPN 47 sets out the safeguards put in place to protect confidentiality and privacy rights and its administrative practice in relation to the exchange of information with Hong Kong's agreement partners.

Effective date of the agreement

The Canadian withholding tax benefits under the agreement will come into effect as of January 1 following the year in which both countries exchange completed instruments of ratification. If both jurisdictions can complete these procedures in the current calendar year, the agreement will be effective as early as January 1, 2013. Otherwise, for Canadian withholding tax purposes, it will be effective on January 1 of a later year. All other Canadian benefits under the agreement will be effective for taxation years beginning on or after January 1 of the calendar year following that in which the agreement comes into force with the exception of certain provisions concerning shipping and air transport.

As regards Hong Kong, the agreement will be effective as early as the year of assessment 2012/13 if it is ratified within the current calendar year. Otherwise, it will take effect only for the year of assessment 2013/14 or even later.

Where to go from here?

For Canadian taxpayers expanding into Asia, the agreement is a welcome development. As noted above, with the agreement in place, dividends from active business earnings from a Hong Kong subsidiary should generally become fully deductible and, hence, not subject to Canadian tax. This is a key benefit to many Canadian multinationals with or contemplating setting up operations in Hong Kong that may wish to repatriate the earnings to Canada.

Many Canadian companies that are considering the Asia Pacific marketplace now have a more robust and efficient basis from which to build. For many, Hong Kong is a natural regional holding company location, and this agreement provides significant tax efficiency in that regard.

For Asian investors, particularly Chinese investors investing into Canada, the agreement also provides a tax efficient platform from which to make Canadian investments. While Hong Kong is already a natural business platform for many Chinese companies, the agreement may enhance opportunities. For example, given that the agreement offers a more favourable dividend withholding tax rate of 5% than the 10% available under the Canada-China treaty, Chinese companies may consider holding their Canadian investments through a Hong Kong holding company rather than directly in order to achieve more tax efficient profit repatriation. Nevertheless, the anti-avoidance rules under the agreement and Chinese domestic general anti-avoidance and beneficial ownership rules should be carefully considered.

Deloitte would be pleased to speak with you on this new development, and how it may benefit you and your business.

Chris Roberge, Hong Kong
Anthony Lau, Hong Kong
Vanessa Poon, Hong Kong
Samantha Tan, Hong Kong