

# Taxing issues

The new double taxation arrangement is far more comprehensive than its predecessor

By Carl Poon and Iris Chiu

**T**he new double taxation arrangement (DTA) is a positive move because of the provision of preferential tax treatment on passive income and the avoidance of double taxation.

Foreign investors may consider benefiting from the new DTA by using Hong Kong companies as an intermediary to invest in the mainland. Foreign investors who are currently using intermediaries incorporated in other jurisdictions could also benefit, but this should be carefully evaluated as it may create immediate tax liabilities.

The main features of the new arrangement include:

## Favourable tax rates

The preferential mainland withholding tax rate on interest and royalty will be seven percent while those on dividends and capital gains on disposal of equity interests will be five or 10 percent for the former and zero or 10 percent for the latter, depending on the level of shareholding in the mainland company (see table).

The mainland withholding tax rate on dividends will be five percent if a Hong Kong company holds at least 25 percent of the capital in a mainland

company. Where the level of ownership is below 25 percent, the withholding tax rate is 10 percent.

For capital gains on disposal of equity interests in a mainland company, Hong Kong is afforded the right to tax if a Hong Kong company has less than 25 percent of the equity interest in the mainland company. Since Hong Kong does not impose capital gains tax, the capital gain is free of tax. Where the disposal amounts to 25 percent or more of the equity interest in the mainland company, the gain may be taxed on the mainland at a rate of 10 percent. Capital gains derived from the disposal of equity interests in a mainland company of which 50 percent or more of the assets consist of immovable property situated on the mainland may also be taxed in the mainland at a rate of 10 percent.

The new DTA effectively exempts capital gains from taxation for the disposal of non-substantial equity interests in mainland companies which do not hold immovable property in the mainland as their main assets.

Mainland tax on capital gains resulting from disposal of substantial interests in a mainland company may be avoided by piecemeal disposals of less than 25 percent of the entire



shareholdings of the company. Both sides may need to provide clarification in this regard. The Departmental Interpretation and Practice Notes (DIPN) No. 32, issued by the Hong Kong Inland Revenue Department in June 1998, provide guidance on how the old arrangement should apply. It is expected that DIPN 32 will be revised to reflect the changes made in the new DTA, possibly including this tax exemption on capital gains.

## Tax deductions

In determining the profits of a permanent establishment, tax deductions will be allowed on expenses incurred for the purpose of the business, including executive and general administrative expenses. However, expenses in the nature of intra-company charges (except for interest charges for banking enterprises) are non-deductible.

## Transfer pricing adjustment

When the tax authority on one side makes an adjustment in a non-arm's



### New tax rates on passive income

	Dividend	Interest	Royalty	Capital gain on disposal of equity interest
Mainland-Hong Kong tax treaty rate	5 or 10% <sup>1</sup>	0 or 7% <sup>3</sup>	7%	0 or 10% <sup>4</sup>
Mainland non-treaty rate	10% <sup>2</sup>	10%	10%	10%

#### Notes

1. The withholding tax rate of five percent applies to dividends paid by a mainland company to its Hong Kong holding company, which holds at least 25 percent of the capital of the mainland company. A 10 percent rate applies in all other cases.
2. Under the prevailing mainland tax regime, dividends paid by a foreign investment company to its foreign investor are currently exempt from withholding tax. Should the exemption be withdrawn, dividends paid to foreign investors may be subject to the original tax rate of 10 percent.
3. The withholding tax rate of zero percent applies to interest received by the government or a mutually recognized institution.
4. The taxing right is allocated to Hong Kong if a Hong Kong company disposes of less than 25 percent equity interest in a mainland company and the assets of that company are not mainly immovable properties situated on the mainland. Since Hong Kong does not tax capital gains, the effective tax rate is zero percent.

For all other cases, the taxing right is allocated to the mainland. The withholding tax rate is 10 percent.

length cross-border related-party transaction, its counterpart on the other side shall make an appropriate tax adjustment. Currently, not all the Chinese tax treaties contain such a provision. The provision is useful for the avoidance of double taxation where a unilateral transfer pricing adjustment is made on one side. The new arrangement, however, also states that the two sides shall consult each other in determining such transfer pricing adjustments where necessary.

### Exchange of information

While the above is favourable to Hong Kong companies, the new article on exchange of information has aroused concerns.

The new DTA states that information is only required where necessary for carrying out the provision of the new arrangement or of the domestic laws of either side concerning taxes covered by the new arrangement.

However, Hong Kong companies have queried what tax consequences may flow from their release of additional information. The two sides need to elaborate on this subject.

It is worth noting that the inclusion of the article on the exchange of information is necessary for a comprehensive tax treaty. The version adopted in the new DTA is based on an old version of the article developed by the Organisation for Economic Co-operation and Development (OECD).

The mainland has been using the more restrictive 2004 OECD version in negotiating new tax treaties or renegotiating existing tax treaties with other countries. The new version is wider in scope and information that can be exchanged would not be limited to that which is necessary, but extended to include what is foreseeably relevant for carrying out the provisions of the tax treaty. Information requested from a contracting state may also include that

which may not be needed for the other state's own purpose.

This more restrictive version has been adopted in the protocol signed on 5 September 2006 with the government of Mauritius to amend the existing China-Mauritius tax treaty.

### Employment income

A Hong Kong employee is exempt from paying PRC tax if on the mainland for a period or periods not exceeding an aggregate of 183 days in any 12-month period instead of a calendar year under the old arrangement.

*The DTA will take effect on 1 January 2007 in the mainland and 1 April 2007 in Hong Kong, subject to the completion of the ratification procedures on both sides.*

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