

# China and Hong Kong Tax Arrangement

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## Comprehensive Double Tax Arrangement between the Mainland of China and Hong Kong

On 21 August 2006, the Central People's Government and the Hong Kong Special Administrative Region Government signed a comprehensive arrangement for the avoidance of double taxation ("the new arrangement") to replace the limited scope arrangement for the avoidance of double taxation signed in 1998. The new arrangement will take effect next year (1 January 2007 and 1 April 2007 in the Mainland and Hong Kong, respectively) subject to the completion of the necessary ratification procedures by both parties before 31 December 2006.

The principal features of the new arrangement include:

### Withholding Tax

	<b>Dividend</b>	<b>Royalty</b>	<b>Interest</b>
China non-treaty rate	0% <sup>1</sup> /20%	10%	10%
Hong Kong non-treaty rate	Nil	5.25%	Nil
Treaty rate	5%/10% <sup>2</sup>	7%	0%/7% <sup>3</sup>

#### Notes:

1. Dividends from foreign investment enterprises with at least 25% registered capital held by foreign investor(s) are specifically exempt under the current Mainland tax law.
2. The 5% withholding tax rate applies to dividends paid by a Mainland company to a Hong Kong resident, provided that the recipient is a company that holds at least 25% of the capital of the Mainland company. 10% in all other cases.
3. The 7% withholding tax rate applies to interest payable from the Mainland; the 0% rate applies to interest received by the Hong Kong Government or recognised institutions.

Although dividends received by foreign investors from a foreign investment enterprise in the Mainland are currently exempt from Mainland taxation, the provision in the new arrangement will provide some protection for Hong Kong investors from any possible withdrawal of this tax exemption at some later stage. It gives a greater level of certainty to those investing into China through Hong Kong. The reduced withholding tax rates on dividends, royalties and interest are amongst the lowest rates available in double tax treaties signed by the Mainland.

### Capital Gains

The new arrangement includes an article on capital gains. Under this article, a full tax exemption in the Mainland is available on a capital gain derived by a Hong Kong investor from the disposal of shares in a Mainland company, provided that the shares sold are less than 25% of the shareholding of the Mainland company and the assets of the Mainland company are not comprised mainly of immovable property situated on the Mainland. However, the implementation of this exemption is subject to the interpretation of the tax authorities in the Mainland.

Given the fact that there is no tax on gains from the sale of capital assets in Hong Kong, this article would effectively give a unilateral benefit to Hong Kong taxpayers. Although the exemption only applies to the sale of a minority interest in a Mainland company, it should still provide a relief for certain Hong Kong investors.

### **Income from Employment**

Under the new arrangement, there is a change in the basis period for counting the number of days of presence in the Mainland for Hong Kong employees frequently visiting the Mainland from a calendar year to any 12-month period.

The change offers no additional protection from double taxation for Hong Kong employees working in the Mainland. Indeed, this change may result in it being harder for some Hong Kong individuals to claim protection from individual taxation in the Mainland.

### **Exchange of Information**

In addition, the new arrangement contains an "Exchange of information" article that is based on the 1995 version of the OECD model convention. Whilst the article does allow certain information to be exchanged between the Hong Kong and Mainland tax authorities to assist them in their tax collection and enforcement activities, it is more restrictive in the scope of information to be exchanged than that contained in the 2004 version which most countries would seek to adopt in their newly negotiated double tax treaties. Under this article, only information necessary for carrying out the provisions of the new arrangement or of the domestic laws of the Mainland or Hong Kong concerning taxes covered by the new arrangement can be exchanged. The governments of both sides are not obliged to supply information which is not obtainable under the domestic laws or in the normal course of administration and which would disclose any trade, business, industrial, commercial or professional secrets, etc.

Businesses on both sides of the border had been concerned about the scope of the exchange of information provisions to be included in the new arrangement. They were worried that it would allow the Hong Kong and Mainland tax authorities to gather more information on their activities, which in some cases might lead to increased taxation burdens. This more restrictive version should be welcome by the businesses on both sides.

### **Limitation on Benefits**

There is no "Limitation on benefits" provision in the new arrangement.

### **Tax Planning**

The tax exemption for capital gains mentioned above and the reduced withholding tax on dividends, royalties and interest would increase Hong Kong's competitiveness and provide added incentives for Hong Kong companies and foreign companies to use Hong Kong to do business or to invest in the Mainland. Tax planning ideas that can be explored include:

1. using a Hong Kong company as an intermediate holding company for holding investments in the Mainland;
2. using a Hong Kong company as a vehicle for financing investments in the Mainland;
3. using a Hong Kong company as a vehicle for licensing intellectual properties to the Mainland.

In the context of this article, China refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. If you are interested in learning more about the new arrangement and its impacts on your company, please contact your PricewaterhouseCoopers client service team or any of the following tax partners at PricewaterhouseCoopers.

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