Hong Kong Tax Alert

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IRD announces it will now issue certificates of "resident of Hong Kong" based on the plain definition of the term under a CDTA

On 8 June 2023, the Inland Revenue Department (IRD) announced on its website that it will now issue certificates of "resident of Hong Kong" (CoRs) based on the plain definition of the term as defined in a comprehensive avoidance of double taxation arrangement (CDTA). Such an approach will apply to all Hong Kong's CDTAs.

Most Hong Kong's CDTAs define a company, partnership, trust, or body of persons to be a "resident of Hong Kong" if it is incorporated or constituted under the laws of Hong Kong. Otherwise, such an entity will be regarded as a "resident of Hong Kong" in most Hong Kong's CDTAs if it is "normally managed or controlled in Hong Kong".

This IRD's announcement seems to indicate that, as a change from its previous administrative practice, the IRD will generally no longer examine whether such an entity has "sufficient economic nexus with Hong Kong" before the IRD issues a CoR for CDTA purposes.

Apparently, where an entity is incorporated or constituted under the laws of Hong Kong, a CoR will, subject to the potential application of the tie-breaker rule, be issued as a matter of course. This would seem to be the case given that such an entity will plainly satisfy the definition of the term in all Hong Kong's CDTAs, except that of the Hong Kong-Japan CDTA.

However, although such an entity will be a resident of Hong Kong, it could also be regarded as a resident of the contracting party of a CDTA, e.g., if its effective place of management is located in the other side. In such a case, the residence of the entity would then have to be decided by the tie-breaker rule contained in the CDTA and the IRD would need to consider the issue when processing the CoR application.

Separately, the IRD has also formalized the application procedures under which CoRs will be issued to more than one applicant where (i) an investment in a mainland China entity is owned via a multi-level ownership structure; and (ii) the entity in Hong Kong that directly owns the mainland China investment cannot be regarded as the beneficial owner of a dividend income on its own, but an upper-level entity in the ownership structure can.

In such a situation, more than one entity in the ownership structure will need to obtain a CoR in Hong Kong under Public Notice No. 9 (PN 9) issued by China State Administration of Taxation in 2018[1], if a reduced withholding tax rate on dividends in mainland China is to apply under the Hong Kong-mainland China CDTA.

It is however unclear whether in processing CoR applications under PN 9, the IRD will, in addition to examining the Hong Kong residence of the entities involved, also examine whether the upper-level entity in Hong Kong is the beneficial owner of the dividends before it issues the CoRs required.

In any case, any claims for tax benefits will also be subject to the examination of the tax authorities of our CDTA partners under the terms of the CDTAs concerned.

The terms of a CDTA that affect the eligibility of an applicant for the tax benefits sought include the resident status of an applicant under a tie-breaker rule, whether the applicant is the beneficial owner of the income concerned and whether a principal purpose of the arrangement in question is to obtain such benefits. Any adverse conclusion of any such other terms of a CDTA could result in the denial of the tax benefits.

Claiming tax benefits under a CDTA is by its nature a complicated process and clients should seek professional tax advice, where necessary.

IRD's change of practice on issuing CoRs after a taxpayer's judicial review

A CoR is issued to a resident of Hong Kong who requires proof of resident status for the purposes of claiming tax benefits under a CDTA.

Previously, the IRD had stated that, apart from promoting trade and investment by eliminating cross-border double taxation, part of the purposes of a CDTA was to prevent tax avoidance.

As such, to uphold the purposes of CDTAs, the IRD had indicated that it would only issue CoRs to residents of Hong Kong who had "sufficient economic nexus with Hong Kong", notwithstanding that the nexus requirement was not specified in any one of Hong Kong's CDTAs.

Presumably, this previous practice was adopted on the grounds that those without the required nexus were only abusing or exploiting the terms of Hong Kong's CDTAs, i.e., engaging in tax avoidance through treaty shopping. The IRD justified such an approach as a purposive interpretation of a CDTA.

However, it is understood that a taxpayer company had recently challenged the IRD in 2022 after the IRD refused to issue to it a CoR for 2021 under the Hong Kong-mainland China CDTA on the grounds that the company had "insufficient economic nexus with Hong Kong".

The company filed a judicial review against the decision of the IRD on the grounds that being a company "incorporated in Hong Kong", it satisfied the term "resident of Hong Kong" as defined under Article 4(1)(2)(ii) of the Hong Kong-mainland China CDTA.

As such, the company contended that the IRD was bound by law to issue to it the CoR given that the term "incorporated in Hong Kong" was a strict definitional provision, the test for the satisfaction of which being an objective fact, regardless of the purposive interpretational approach taken by the IRD on the term.

1. 关于税收协定中“受益所有人”有关问题的公告（chinatax.gov.cn）

Understandably, after receiving legal advice, the IRD decided not to contest the judicial review and then agreed to issue the requested CoR under the original application made by the company.

Now, about one year after the settlement of the judicial review referred to above, the IRD has made an announcement that in future it will issue a CoR based plainly on how the term "resident of Hong Kong" is defined in a CDTA.

Practical implications of the IRD's stated revised practice on issuing CoRs

Except for the Hong Kong-Japan CDTA, a company, partnership, trust, or body of persons will be a "resident of Hong Kong" as defined in all other CDTAs, if it is incorporated or constituted under the laws of Hong Kong. Otherwise, it will also be a resident of Hong Kong in most Hong Kong's CDTAs, if it is "normally managed or controlled in Hong Kong".

The concept of "normally managed or controlled in Hong Kong", as compared to that of "central management and control" established in common law, has a broader meaning as it does not require that both management and control be exercised in Hong Kong.

"Management", in this context, refers to management of daily business operations, or implementation of the decisions made by top management, etc. "Control", on the other hand, refers to control of the whole business at the top level, including formulating the central policy of the business, making strategic policies of the company, choosing business financing, evaluating business performance, etc. The board of directors or governing body of such entities usually exercises "control" of the entities concerned.

In other words, if the business of an entity is normally managed or controlled in Hong Kong, including the management of its daily business operations, or the implementation of the decisions made by top management, or the making of top-level policies, in Hong Kong, the company will be considered to be a resident of Hong Kong. The "management" or "control" of a company may, of course, be conducted in more than one place. However, so long as a company is normally managed or controlled in Hong Kong, it will be considered to be a resident of Hong Kong.

As such, under the IRD's stated revised practice, apparently where an entity is incorporated or constituted under the laws of Hong Kong, a CoR will, subject to the potential application of the tie-breaker rule, be issued as a matter of course. This would seem to be the case given that such an entity will plainly satisfy the definition of the term in all Hong Kong's CDTAs, except that of the Hong Kong-Japan CDTA.

However, although such an entity will be a resident of Hong Kong, it could also be regarded as a resident of the contracting party of a CDTA, e.g., if its effective place of management is located in the other side. In such a case, the residence of the entity would then have to be decided by the tie-breaker rule contained in the CDTA and the IRD would need to consider the issue when processing the CoR application.

If an entity is "normally managed or controlled in Hong Kong", it must have some presence in Hong Kong. However, while "normally managed or controlled in Hong Kong" and "sufficient economic nexus with Hong Kong" may to some extent overlap, the two terms may not be the same with the former term conceivably being more objective than the latter.

It is however still unclear whether in processing CoR applications under PN 9, the IRD will, in addition to examining the residence of the entities involved in a multi-level ownership structure, also examine whether the upper-level entity is the beneficial ownership of the dividend income concerned.

In the case of the Hong Kong-Japan CDTA, the term "resident of Hong Kong" of a company, partnership, trust, or body of persons is defined as the entity "having a primary place of management and control in Hong Kong". Under the IRD's stated revised practice, the IRD will examine whether the "primary place of management and control" of the entity is in Hong Kong, the latter term conceivably not being the same as having "sufficient economic nexus with Hong Kong".

Formalization of application procedures for CoRs to be issued under PN 9

In the aforesaid announcement, the IRD also provided a hyperlink to the revised CoR application forms for a company, partnership, trust, or body of persons for the Hong Kong-mainland China CDTA and other Hong Kong's CDTAs (i.e., Form IR 1313A and Form IR1313B respectively). Other revised forms for Hong Kong resident individuals applying for a CoR under the Hong Kong-mainland China CDTA and other Hong Kong's CDTAs are also provided in the revised Form IR1314A and Form IR1314B respectively.

Of all the changes made to the various forms, the most significant ones are those made to the revised Form IR1313A applying for CoRs under PN 9 under the Hong Kong-mainland China CDTA. Revised Form IR1313A now specifies the procedures and details of the relevant information required, including:

- Details of the information as to (i) whether the entity that directly owns the mainland China investment and the upper-level entity that is the beneficial owner of the dividend income are both residents of Hong Kong such that "the same jurisdiction" rule applies; and, if not, whether "the same treaty benefit" rule applies; and (ii) whether the entity that directly owns the mainland China investment is 100% directly or indirectly owned by a Hong Kong resident listed company; and/or a Hong Kong resident individual and/or the Hong Kong government such that "the safe harbor" rule applies.

- The name, address and Hong Kong business registration number of the lead applicant in the multi-level holding structure and details of any change in equity interest of any entity during the 12 consecutive months before dividends were or are to be received.

Please also refer to Appendix to this alert for a detailed explanation of "the same jurisdiction" rule, "the same treaty benefit" rule and "the safe harbor" rule under PN 9.

Commentary

Despite the IRD's stated revised practice on issuing CoRs based on the plain definition of the term "resident of Hong Kong" under a CDTA, claiming tax benefits under a CDTA is by its nature a complicated process.

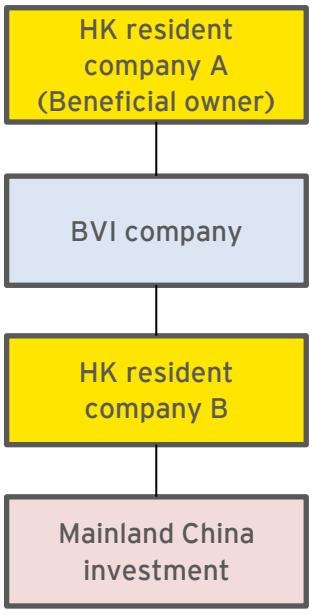
This would be the case given that, in addition to obtaining a CoR in Hong Kong, any claims for such benefits will also be subject to the examination of the tax authorities of our CDTA partners under the terms of the CDTAs concerned.

The terms of a CDTA that affect the eligibility of an applicant for the tax benefits sought include the resident status of an applicant under a tie-breaker rule, whether the applicant is the beneficial owner of the income concerned and whether a principal purpose of the arrangement in question is to obtain such benefits.

Any adverse conclusion of any such other terms of a CDTA could result in the denial of the tax benefits sought. Where necessary, clients should seek professional tax advice.

Appendix

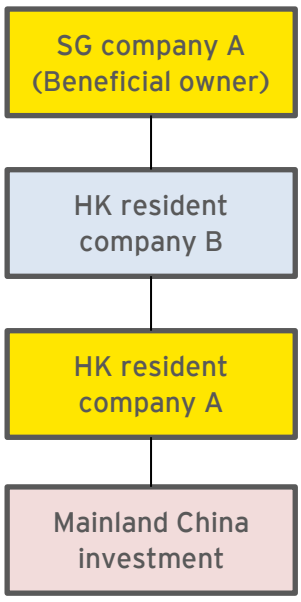
1. The "same jurisdiction" rule specified in Article 3(1) of PN 9 refers to the situation where the entity that directly owns the mainland China investment (i.e., the recipient of the dividend income) and the upper-level entity that is the beneficial owner of the dividend income are both residents of Hong Kong as shown below.



In such a situation, despite HK resident company B does not qualify as the beneficial owner of the dividend income on its own, it can still be deemed to be the beneficial owner under the "same jurisdiction" rule if HK resident company A qualifies as the beneficial owner of the dividend income.

As a matter of procedures, both HK resident company B and HK resident company A will need to apply for a CoR in Hong Kong. Though strictly not a requirement under PN 9, many taxpayers would, in practice, also apply for a CoR in Hong Kong for the intermediate BVI company.

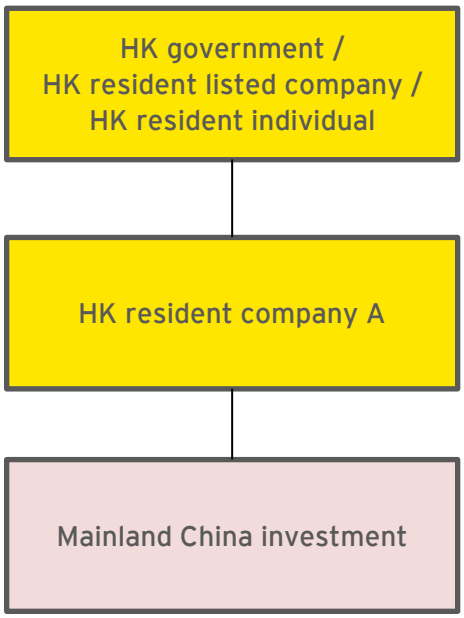
2. The "same treaty benefit" rule specified in Article 3(2) of PN 9 refers to the situation where the entity that directly owns the mainland China investment (i.e., the recipient of the dividend income) is a Hong Kong resident but the upper-level entity that is the beneficial owner of the dividend income is not a Hong Kong resident as shown in the diagram below. In such a situation, all the other upper-level entities will need to be a "qualified person". An entity would be a "qualified person" if its residence jurisdiction has a CDTA with China that confers the same or more preferential tax benefit than that under the Hong Kong-mainland China CDTA.



In such a situation, despite HK resident company A does not qualify as the beneficial owner of the dividend income on its own, it can still be deemed to be the beneficial owner under the "same treaty benefit" rule given that the Singapore-China CDTA offers the same tax benefit in terms of reduction in withholding tax rate on dividends in China as that under the Hong Kong-mainland China CDTA.

As a matter of procedures, both HK resident company A and HK resident company B will need to apply for a CoR in Hong Kong under PN 9.

3. The "safe harbor" rule specified under Article 4 of PN 9 refers to the situation where the entity that directly owns the mainland China investment is 100% directly or indirectly owned by any one or the combination of any one of the following entities: (i) the Hong Kong government; (ii) a Hong Kong resident listed company; or (iii) a Hong Kong resident individual as shown below. In such a situation, the entity that directly owns the mainland China investment will automatically be recognized as the beneficial owner of the dividend income from the mainland China investment.



As a matter of procedures, where applicable, both HK resident company A, HK resident listed company, HK resident individual and the Hong Kong government will need to apply for a CoR in Hong Kong, under PN 9.

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