

## LEGAL FRAMEWORK OF TAXATION IN HONG KONG

Carol Gaw<sup>1</sup>

This paper introduces the legal framework of the Hong Kong tax régime. Specifically, this paper discusses the general principles regarding profits tax and salaries tax, the two main kinds of income taxes levied in Hong Kong. Lastly, the advantages of setting up Hong Kong companies by foreign investors as investment holding entities for making investments into China are discussed as well.

### General Introduction

There are three types of income tax levied in Hong Kong:

- *profits tax*, which is levied on business income (whether earned by corporations or individuals),
- *salaries tax*, which is levied on employment income, and
- *property tax*, which is levied on all rents from real property received by individuals. (Corporations would be subject to profits tax on such income.)

### Profits Tax

#### I. General Principles

The Hong Kong profits tax system is based on a territorial concept. Pursuant to Section 14 of the Inland Revenue Ordinance (IRO), in order for a person (including corporation, partnership, trustee and body of persons) to be chargeable to Hong Kong

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<sup>1</sup> The author is a Vice President with the Trust & Legal Team with HSBC Guyerzeller Bank AG. HSBC Guyerzeller Bank AG is a private bank founded in 1894 in Switzerland.

profits tax, the following three conditions must be satisfied:

- the taxpayer must carry on business in Hong Kong,
- the taxpayer must earn profits from that business, and
- those profits must have a Hong Kong source.

Offshore profits are not subject to profits tax. The source rules are detailed in section II below.

In addition to the above provision, there are specific sections which deem the conditions for chargeability to be met in respect of certain items where the above conditions would not otherwise be met (see section III below).

Unlike the position in most other jurisdictions, the place of residence or domicile of the person (and the place of incorporation in the case of a company) plays no part in determining whether HK tax liability exists and the quantum of any such liability. Accordingly, non-residents are subject to profits tax in exactly the same way as residents and non-Hong Kong companies are taxed in the same manner as Hong Kong companies.

Starting from 1st April 2005, the profits tax rate for companies in Hong Kong is 17.5% on net profits (as adjusted for tax purposes). For individuals, the rate is 16%.

Hong Kong has not entered into any tax treaty with any other country. The only exceptions are the limited agreement with the USA concerning shipping income and the Prevention of Double Tax Arrangement with China.

There are provisions giving partial credit for taxes paid in Commonwealth countries. However, these provisions are limited. Because Hong Kong taxes only profits which are sourced in Hong Kong, double taxation is rarely a problem in practice.

Unutilized trading losses and capital allowances of a corporation can be carried forward indefinitely and offset against future profits from the same or any other business. There is no provision for group loss relief. Nevertheless, losses may be utilized by associated companies through the provision of intra-group charges for services rendered by the loss company to the associated company.

The deductibility of carry-forward losses may be denied if there is a change in shareholding in the relevant corporation, and if the tax authorities conclude that this change was effected for the dominant purpose of enabling the purchaser to take advantage of those losses.

**A. Profits Tax / Withholding Tax Liability of Foreign Corporations**

Generally, foreign corporations that are not carrying on a trade or business in Hong Kong would not be liable to Hong Kong profits tax nor withholding tax unless they derived deemed Hong Kong sourced trading income (see section III below).

On the other hand, foreign corporations that are considered to be carrying on a trade or business in Hong Kong would be liable to Hong Kong profits tax if they have derived Hong Kong-sourced income.

A foreign corporation is chargeable to tax either directly or in the name of its agent in respect of all its trading profits arising in or derived from Hong Kong, whether or not the agent has the receipt of profits, the tax may be recovered out of the assets of the non-resident or from the agent. The agent is required to retain from the assets sufficient money to pay the tax.

**B. Carrying on a Business in Hong Kong**

Whether an entity is carrying on a business in Hong Kong is a matter of fact. An entity could be carrying on a business in Hong Kong without having a legal establishment. A taxpayer may be regarded as carrying on a business in Hong Kong if its central management and control is in Hong Kong or if its business activities are conducted through an agent in Hong Kong.

Normally, if the board meetings are held in Hong Kong, the daily business decisions are made in Hong Kong or the daily business operations are carried out in Hong Kong, the entity will be treated as centrally managed and controlled in Hong Kong and hence carrying on a business in Hong Kong.

**C. Carrying on a Business in Hong Kong through an Agent**

A non-resident company would be regarded as carrying on a business in Hong Kong if its business activities are conducted through an agent in Hong Kong. According to Inland Revenue Rule 5, a foreign entity would be considered to have a “permanent establishment” in Hong Kong by virtue of having an agent if the agent:

- has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of its principal;
- has a stock of merchandise from which the agent regularly fulfils orders on its behalf.

In certain special cases, profits arising in Hong Kong other than from a trade, profession or business carried on in Hong Kong such as income from the use of copyright material in Hong Kong are nevertheless deemed to be derived from a business carried on in Hong Kong.

## **II. Source Rules**

The source of profits for Hong Kong profits tax purposes had been considered in various court cases. However, there is no hard and fast rule for source determination. The question of source of profits is a matter of fact. It is one of the areas which have produced many controversies. Each case is considered based on facts and circumstances. The broad guiding principle is to see what the taxpayer has done to earn the profits in question. Nevertheless, the Hong Kong Inland Revenue Department (IRD) has issued a Departmental Interpretation & Practice Note (DIPN 21) as a guideline for determining the source of different types of profits.

### **A. Trading Profits**

According to the DIPN21, the source of profits derived from a trading business is decided by the following factors:

- The place where the purchase contracts are effected; and
- The place where the sale contracts are effected.

Only if both the sale and purchase contracts are effected outside Hong Kong, will the trading profits be regarded by the IRD as offshore in nature and non-taxable.

### **B. Service Income**

Service income is sourced according to the location where the services are performed.

### **C. Manufacturing Income**

Manufacturing come is sourced at the place where manufacturing activity is carried out.

### **D. Royalty Income**

Pursuant to Section 15(1)(b) of the IRO, sums received for the use of a patent, design, trademark, copyright material, secret process formula or

other property of a similar nature, or for imparting or undertaking to impart knowledge directly or indirectly connected with the right to use in Hong Kong are deemed to be Hong Kong-sourced trading receipts and thus are subject to Hong Kong profit tax.

#### E. Interest Income

The general rule is that interest has an offshore source if the lender first makes the loan funds available to the borrower outside Hong Kong (for example, by depositing them into the borrower's offshore bank account). Interest on deposits held in an offshore bank account is treated as having an offshore source and is therefore tax-free.

Banks and deposit-taking companies have less flexibility in arranging for their interest income to have an offshore source. Generally, *all* of their *interest* income will be taxable if it arises through or from the carrying on of their business in Hong Kong.

### III. Withholding Taxes

Capital gains are exempt from tax.

Dividends are also exempt from tax.

Rental income from chattels which are located in Hong Kong will be subject to profits tax.

Interest is not subject to any withholding tax. Interest is therefore taxable only if the recipient is carrying on a trade, profession or business in Hong Kong and has derived Hong Kong sourced interest.

Royalties are subject to withholding tax if paid to a non-resident for the use in Hong Kong of intellectual property rights (including know-how). The deemed net profits rate is 30% of the gross revenue. The withholding rate on royalties is 5.25% in the case of corporate recipients and 4.8% in the case of individuals respectively of the gross amount paid. The withholding rate is 17.5% (16% for individuals) if the relevant intellectual property right was previously owned by a person carrying on business in Hong Kong.

Management and service fees are not subject to withholding tax. Such fees are not subject to any Hong Kong tax if the relevant services are performed outside Hong Kong.

Other types of withholding taxes apply in the following cases:

- *Agent in Hong Kong:* Where a person, who does not have a permanent business presence in Hong Kong, derives taxable income through an agent, that person can be taxed by an assessment raised on the agent. The agent is obliged to retain out of assets coming into its possession on behalf of the principal an amount sufficient to cover such tax liability.
- *Consignment sales:* A person who, as agent, sells goods in Hong Kong on behalf of a non-resident person who does not have a permanent business presence in Hong Kong must deduct a sum of 0.5% of the gross sale proceeds, and furnish quarterly returns to the tax authorities. (This rate can be reduced with the approval of the tax authorities.)
- *Visiting entertainers and sportsmen:* Amounts paid to a non-resident entertainer or sportsman are subject to withholding at the appropriate tax rate (17.5% for corporations and 16% for individuals) on two-thirds of such fees. (This amount can be reduced with approval of the tax authorities.)

In the last two cases, the tax withheld is not final. The recipient can file a tax return claiming a refund if, in fact, its taxable profits are less than assumed. If the recipient's taxable profits are greater than assumed, however, the tax authorities will not seek to claim any further tax.

## **Salaries Tax**

### **I. General Principles**

Income from Hong Kong sources from an employment or office (including directors' fees) is subject to salaries tax. Pensions having a Hong Kong source are also subject to salaries tax.

### **II. Source Principles**

#### **A. Source of Office Income**

The source of income from an office is the place where that office is exercised. A fee earned by a director of a company, whose central management and control is in Hong Kong, is treated as having arisen from a Hong Kong source.

## B. Source of Employment Income

A person who visits Hong Kong for not more than 60 days in the relevant tax year will generally not be subject to tax on his or her salary. (Stricter rules apply for air and ship crew who, in addition, must not spend more than 120 days in two consecutive tax years in Hong Kong if their salaries are to be exempt, and for Hong Kong government employees for whom no such exemption is applicable.)

Subject to the 60-day rule above, salary which is attributable to services performed in Hong Kong is liable to salaries tax.

Salary which is attributable to services performed outside Hong Kong will be tax-free if the employee has an offshore contract of employment. As a practical matter, the following factors will point to an offshore contract of employment:

- The employer is resident outside Hong Kong. (A corporate employer is treated as resident in the place where its central management and control is located.)
- The contract of employment was negotiated and entered into outside Hong Kong, and is enforceable outside Hong Kong.
- The employee receives his or her remuneration outside Hong Kong.

These factors are not conclusive. If the first two factors apply, then the fact that the employee receives remuneration in Hong Kong will generally be disregarded. Where the employer is resident in Hong Kong, this factor alone dictates that the contract is not offshore.

In the case of a travelling employee who works for substantial periods both inside and outside Hong Kong (but for at least 61 days inside Hong Kong), all of his or her salary will be taxable if there is a Hong Kong contract of employment. If there is an offshore contract of employment, the employee's salary will be apportioned on a "days-in/days-out" basis. Where the employer is resident in Hong Kong, it follows that apportionment is not possible and the whole of the employee's salary will be taxable. In this case, "dual contracts" could be entered into in appropriate cases for the purpose of achieving such apportionment. This involves the employee entering into a contract of employment with an employer who is a Hong Kong resident with respect to services to be performed in Hong Kong, and into a second contract of employment with an affiliated employer who is not a Hong Kong resident with respect to services to be performed outside Hong Kong.

Where an employee would otherwise be subject to salaries tax with respect to salary for services rendered outside Hong Kong, an exemption applies if that salary is subject to tax in the country in which the services were performed. This exemption applies regardless of the rate of tax payable in that other country.

The source of a pension is generally taken to be the place where the fund, out of which the pension is paid, is managed and controlled.

Taxable salaries income includes all wages, leave pay, perquisites and allowances. Non-cash benefits are taxable if they are convertible to cash in the hands of the employee. If the employer pays a debt which is owed by the employee to a third party, the amount so paid is also taxable to the employee. Furthermore, if the employer itself incurs an expense for the benefit of the employee, the amount involved is taxable to the employee unless the expense represents a debt owed solely by the employer, which is not guaranteed by any other person (such as the employee). Fringe benefit planning is common in Hong Kong.

Free or subsidized accommodation, or the payment or reimbursement of rent or rental allowances, is tax-free. In lieu, the employee is taxed on a "rental value" which is equal to 10% of his or her otherwise taxable earnings.

Salaries tax is levied on a sliding scale, as follows:

Chargeable income (HK\$)	Rate %
First \$30,000	2%
Next \$30,000	8%
Next \$30,000	14%
Remaining	20%

However, this is subject to a maximum amount of tax which is equal to 16% of the whole of the employee's chargeable income (without deduction of personal allowances).

### **Advantages of Setting up Hong Kong Companies**

Since the opening of China's economy some twenty year ago, Hong Kong has become the gateway for trade and investment into the mainland and as a headquarters for mainland-related operations. Hong Kong companies have been widely used by

foreign investors as holding companies for making investments into China due to numerous attractions. These attractions include Hong Kong's location and port, duty-free imports of most products, free movement of money, low and simple taxes, few regulations on normal business operations, broad freedom of contract, predictable resolution of disputes under a common law legal system, and relatively widespread English language ability.

Hong Kong companies are easy to incorporate and it can be set up in a short period of time (about 6–8 working days). Alternatively, shelf companies are easily available. One director and one shareholder are required for each company. The director and shareholder can be corporations or individuals. There is no residency requirement for director or shareholder. The authorized capital of the company can be in any currency. There are no minimal capital requirements; furthermore, thin capitalization rules do not apply in Hong Kong.

Low and simple taxes and duties are the cornerstone of Hong Kong's continuing attractions, especially for highly paid personnel and high value-added activities. As discussed above, a company conducting business in Hong Kong is liable for tax at a flat rate set in recent years at 17.5%, which applies only to profits from the carrying on of a business in Hong Kong, and in general does not apply to interest, dividends, or capital gains. An individual working in Hong Kong is liable for tax at a flat rate of 16%, which applies only to salaries, including bonuses and commissions, and excludes interest, dividends, and capital gains.

In recent years, there has been an increase in the use of Hong Kong companies by foreign investors for making investments in China. Hong Kong companies are regarded as "foreign investors" for Chinese tax purposes and they are entitled to all kinds of tax breaks granted by the Chinese government to foreign investors. In addition, Hong Kong has entered into an arrangement with China to avoid double taxation on the same income by both sides. According to the arrangement, royalties derived by Hong Kong companies from China are generally subject to a reduced withholding tax at 10% and a business tax at 5%. Interests derived by Hong Kong companies from China are also subject to a reduced withholding tax at 10%. Dividends paid to foreign investors are currently exempt from tax. Hong Kong does not tax offshore income. Therefore, income (for instance, royalties, interest and dividend) of the subsidiaries or branches, which carry on business in China, of Hong Kong companies are completely exempt from tax in Hong Kong.

## **Conclusion**

Hong Kong has a territorial tax system. Although not a tax haven, Hong Kong enjoys relatively low tax rates. Hong Kong companies are easy to set up and to administer.

The low and simple tax system is one of the key factors which attract many foreign companies to set up presence in Hong Kong for conducting businesses in the region.