Global tax guide to doing business in Hong Kong

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Overview

Hong Kong has a territorial basis of taxation, where profits tax is imposed on assessable income or profits arising in or derived from Hong Kong by persons carrying on a trade, profession or business in Hong Kong, unless specifically exempted from tax under the Inland Revenue Ordinance (IRO).

Under such territorial basis of taxation, the chargeability to tax is determined on the source of income as opposed to the residence status. As such, a non-resident may be liable to tax in Hong Kong in respect of assessable profits which are attributable to a trade or business carried on in Hong Kong and which have a Hong Kong source. Whether a trade or business is carried on in Hong Kong and whether profits are derived from Hong Kong is a question of fact and subject to application of law and principles for which case law provides some guidance. Relevant operations do not comprise the entirety of the taxpayer's activities as they are considered distinct from activities incidental or antecedent. In practice, the Hong Kong Inland Revenue Department has clarified that the concept of carrying on business in Hong Kong is generally broader than the definition of permanent establishment in the IRO and in double tax agreements (DTA) concluded by Hong Kong. Conversely, under Hong Kong's territorial source-based taxation system, tax is not levied on the basis of remittance or receipt in Hong Kong. Profits sourced outside Hong Kong fall outside the charge to tax in Hong Kong.

Hong Kong has enabled its participation in the Multilateral Convention on Mutual Administrative Assistance in Tax Matters by aligning the IRO with initiatives on international tax co-operation, including the automatic exchange of financial account information in tax matters and combating base erosion and profit shifting (BEPS). Hong Kong has committed to the implementation of the four minimum standards of OECD's BEPS Action Plan, namely: (i) countering harmful tax practices (Action 5); (ii) preventing treaty abuse (Action 6); (iii) imposing country-by-country (CbC) reporting (Action 13); and (iv) improving the cross-border dispute resolution regime (Action 14). Hong Kong has amended the IRO and codified transfer pricing rules, spontaneous exchange of information with regard to tax rulings, country-by-country reporting requirements and cross-border dispute resolution mechanism, among others.

In this chapter

- Legal system
- Taxation authorities
- Business vehicles
- Financing a corporate subsidiary
- Stamp Duty
- Corporate income tax
- Cross-border payments
- Double Taxation Relief
- Multilateral Instrument

- Anti-Avoidance
- Donations
- Value Added Tax
- Payroll taxes

Legal system

Hong Kong operates under a common law legal system, which can be traced back to the English legal system. The primary sources of law for Hong Kong are the enacted statues of the Legislative Council of Hong Kong and case law.

Taxation authorities

Hong Kong has a distinct taxation system which is independent of the one in Mainland China, and the key statue is the IRO, and the taxation authority is the Hong Kong Inland Revenue Department (IRD).

Business vehicles

Company with Limited Liability

The most common form of business vehicle in Hong Kong is the company with limited liability, which is a separate legal entity. There are multiple forms, being categorized as private and public companies limited by shares and companies limited by guarantee. Being a separate legal entity gives owners of the business the advantage of not being personally liable for the debts and obligations of the business, and are only liable to the extent of the capital they invest in the business. Changes in shareholding or membership do not affect the operations of the company as shares can easily be transferred from a procedural perspective, and a company has perpetual succession, meaning the existence of the company entity is not contingent on any member of the company.

Of the three primary forms of companies with limited liability:

i. Private company limited by shares, being the most common form of business in Hong Kong, incorporated with at least one shareholder, at least one director, and a secretary (who must be a Hong Kong resident). For a private company, the maximum number of shareholders is 50, there are also no requirements regarding share capital. Upon company liquidation, the assets will be first to satisfy the claims of creditors, and remaining assets (if any) will be distributed proportionately among shareholders.
ii. Public company limited by shares, which may have more than 50 members and typically the form of company for having its capital divided into shares and listed on the Hong Kong Stock Exchange.
iii. Company limited by guarantee, often the form of entity adopted by non-profit organisations, with the liability of the members limited by guarantee rather than share capital. The liability of its members is limited to the agreed amount to contribute to its business activities in the event of a liquidation.

Sole proprietorship

In a sole proprietorship, there is no distinction between the business as the operating entity and the sole owner. The owner is fully liable for the debts and obligations of the business. An advantage of this form of business is that the income derived from this business is taxable at 15% instead of the corporate tax rate of 16.5%, as it is an unincorporated form of business.

Partnership

There are 2 principle forms of partnerships in Hong Kong:

i. General partnerships, established pursuant to a partnership agreement between two or more partners who are personally liable with their personal assets for the debts and obligations of a company (similar to a sole

proprietorship).

ii. Limited partnerships, established with at least one limited partner who is only liable to the extent of his contribution for the company's capital, and at least one general partner who is fully liable for the partnership's debts and obligations.

Both forms are viewed as unincorporated businesses, as such, income derived from such a business is taxable at 15% instead of the general corporate tax rate of 16.5%.

A partnership is required to file a partnership tax return for profits tax, with the statement of financial position/balance sheet and the statement of income/profit and loss account, with a tax computation to determine the amount of assessment profits (or adjusted loss) of the partnership. The partners are subject to tax on the allocated profits or loss according to the sharing ratio, and may elect for personal assessment on such tax.

Branch

A branch is not viewed as separate legal entity, rather it is viewed as an extension of a parent company. A branch is able to conduct business activities, however it has no separate ownership or identity from its parent company, and as such the parent company is liable for all debts and obligations of the branch. Branch offices are essentially different from subsidiaries which are separate legal entities. Under the Companies Ordinance, a foreign or non-Hong Kong company which has established a place of business in Hong Kong is required to be registered with the Companies Registry and also file a business registration with the Inland Revenue Department.

Branches or registered non-Hong Kong companies and incorporated Hong Kong subsidiaries of foreign companies are taxed on the same basis and at the same rates. Accordingly, there are theoretically no noteworthy differences. However, practical differences could arise in respect of (amongst others) the attribution of profits and expenses between the head office and the branch.

Open Ended Fund Companies

Open Ended Fund Companies (OFCs) are investment funds set up in the form of a company, providing a structure that affords flexibility for investors to contribute or withdraw capital to or from the fund through the creation or cancellation of shares in the fund company. The Securities and Futures Commission is the primary regulator for the OFC structure, which oversees and approves the incorporation and registration of OFCs, as well as ongoing regulation of OFCs.

Under Hong Kong's unified funds tax exemption in place since April 2019, OFCs as well as non-resident funds may, subject to meeting relevant criteria and conditions, be exempt from profits tax on profits made by qualifying transactions (and incidental transactions up to 5% of the fund's trading receipts). Qualifying transactions are defined in Schedule 16C of the Inland Revenue Ordinance, which includes but is not restricted to, transactions involving securities, stocks, shares, and futures contracts.

Limited Partnership Funds

Since August 2020, a new Hong Kong domiciled fund structure is available in the form of the limited partnership fund (LPF), under the Limited Partnership Fund Ordinance. Besides the unified funds tax exemption which may apply to qualifying LPFs for profits tax exemption, operators of LPFs may also be granted concessionary zero tax rate on a carried interest from the LPF, subject to meeting prescribed conditions and being approved as eligible under a scheme to be administered by the Hong Kong Monetary Authority.

Financing a corporate subsidiary

Currently, Hong Kong does not have thin capitalisation rules. Loans entered into between related parties are, however, subject to transfer pricing rules, under which interest is to be determined for tax purposes at an arm's length rate. Interest payments are tax deductible against income if wholly and exclusively incurred in producing the income.

Hong Kong has specific limitations on the deduction of certain interest expenses, particularly with respect to interest paid to non-residents, even before BEPS. However, Hong Kong does not impose withholding tax on interest.

Stamp Duty

Stamp duty is charged on the transfer or sale of Hong Kong stocks or immovable properties. For Hong Kong stocks this is at 0.26% of the exchange price (or market price if it is higher). "Hong Kong stock" refers to stock, the transfer of which is required to be registered in Hong Kong, and "stock" is defined to include (but is not restricted to) shares, bonds, debentures and securities.

For the conveyance of immovable property in Hong Kong multiple tax rates are applicable depending on the value and nature of the property. This is separated into 3 general categories:

i. Residential property: Flat rate of 15%, with exemptions
ii. Acquisition of a single residential property by a Hong Kong resident without any other residential property in Hong Kong SAR at the time of conveyance. This ranges from HKD 100 to 4.25% of the property consideration and is dependent on the value of the property consideration.
iii. Non-residential property is taxed on a scale that ranges from HKD 100 to 4.25% of the property consideration and is dependent on the value of the property consideration.

Corporate income tax

Profits Tax

A company is resident in Hong Kong if its central management and control is exercised in Hong Kong in the relevant year of assessment. However, as noted above, under Hong Kong's territorial basis of taxation, the chargeability to tax is generally determined on the source of income rather than on residence status. Where applicable, the residence status becomes relevant if seeking treaty benefits under applicable DTA provisions.

A 'two-tiered' profits tax rates regime (instead of the previous flat rate of 16.5%) applies to any year of assessment commencing on or after April 1, 2018. The rate for the first HKD 2 million of profits of corporations will be lowered to 8.25%. Assessable profits exceeding that amount will continue to be subject to the rate of 16.5%. For unincorporated businesses (i.e., partnerships and sole proprietorships), the two-tiered rates will be set at 7.5% and 15%, respectively. As a result, a tax-paying corporation or unincorporated business may save up to HKD 165,000, respectively, HKD 150,000 each year. All entities with profits chargeable to Hong Kong profits tax are eligible for the two-tiered profits tax rates. However, if the entity has one or more connected entity, only the one which is nominated to be chargeable for the two tiered rates qualify for the two-tiered rates. Other exemptions to this regime include qualifying professional insurance businesses, authorized captive insurance businesses, corporate treasury centers, and aircraft lessors or leasing managers.

For Hong Kong profits tax purposes, the tax base is determined on the (audited) accounting profit subject to tax adjustments. Hong Kong applies a territorial basis of taxation, whereby tax is imposed on assessable income or profits arising in or derived from Hong Kong sources, or deemed as such.

Under Hong Kong's territorial basis of taxation, as explained above, the chargeability to tax is determined on the source of income as opposed to the residence status. As such, a non-resident can also be held liable for tax in Hong Kong in respect of assessable profits which are attributable to a trade or business carried on in Hong Kong and which have a Hong Kong source. In practice, the IRD has clarified that the concept of carrying on business in Hong Kong is generally broader than the definition of permanent establishment in the IRO and DTAs concluded by Hong Kong. Hong Kong's territorial basis of taxation serves, to a large extent, as a measure of unilateral relief from double taxation, since most persons are not taxed on non-Hong Kong sourced income.

A deduction may be available for foreign tax paid in connection with interest or profits from the disposal or redemption of certificates of deposit and bills of exchange which are deemed to be derived from a trade or business carried on in Hong Kong. As most persons are not taxed on foreign income, the deduction is actually limited to financial institutions.

Although Hong Kong does not have a patent box regime, it does have various other preferential tax regimes and concessions, such as (but not limited to) profits tax exemption for funds (regardless of their location of central management and control, subject to meeting certain conditions for profits tax exemption on qualifying or specified

assets or transactions), a notional tax regime for profits in connection with qualifying aircraft leasing and/or management activities, qualifying corporate treasury centers, tax concessions for gains derived from qualifying debt instruments, concessions for captive insurers reinsurance companies, enhanced tax deductions for qualifying R&D expenditure, outright or accelerated tax deductions for qualifying environmental-friendly investments, etc.

Currently, the IRO does not contain any provisions that deal specifically with e-commerce. As such, to determine if income in connection with digital activities constitute assessable profits, the general taxation principles (and relevant case law) and relevant 'deeming provisions' under the IRO with respect to sums which are chargeable to profits tax as royalties or license fees for intellectual property may apply. Broadly speaking, the IRD has expressed its view that e-commerce is treated on the same basis as 'conventional' forms of business and no particular business form should have either an advantage or a disadvantage for profits tax purposes in Hong Kong.

Hong Kong has not expressed any (formal) opinion on the 'Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy' yet. Nonetheless, since Hong Kong has been using its utmost efforts to comply with evolving international standards and is committed to the ongoing implementation of (the four minimum standards of) the OECD's BEPS Action Plan (including Action 5 on countering harmful tax practices), it is expected that the Government will continue its positive approach in taking necessary measures once a unified approach has been reached by the G20/OECD.

Capital Gains

There is no capital gains tax in Hong Kong, hence gains in the nature of capital (not being in the nature of profits from a trade or business) are not subject to profits tax. Whether a gain is regarded as capital or revenue in nature is a question of fact and depends on the particular circumstances of each case. Generally speaking, considering the frequency of an entity's normal course of business or trading activities, gains derived from such business or trading activities routinely carried out would in practice usually be regarded from a profits tax perspective to be in the nature of revenue. Conversely, capital losses are not deductible for profits tax purposes.

Computation of taxable income

Profits tax applies only to income sourced in Hong Kong, and income (including dividend income) received by a local company from a non-resident company is generally not subject to profits tax in Hong Kong, as they are not Hong Kong-sourced. Expenses, where revenue in nature and incurred in the production of (Hong Kong) assessable profits, are in principle tax deductible. Typical adjustments in this regard include depreciation and amortisation in respect of capital expenditure, intangible assets and interest.

Losses of a revenue nature can generally be carried forward indefinitely and set off against chargeable profits in the future. However, losses may not be carried back. In principle, a transfer of shares in a Hong Kong company does not affect the availability of the tax losses of that company, unless the change in the company's shareholders is effected for the sole or dominant purpose of using the tax losses of the Hong Kong company. Any unused tax losses incurred by the transferor cannot be transferred to the transferee on the sale of the business or the assets of the transferor. Both the retention and distribution of profits made by Hong Kong companies are not chargeable to tax.

There is no withholding tax on acquisitions that take the form of a purchase of shares of a company as opposed to a purchase of its business and assets. Taxpayers are subject to profits tax on their profits arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong, except for any profits realised from sales of capital assets, which are not within the chargeable scope of profits tax. As such, sellers are able to dispose of equity investments free of profits tax.

In contrast, sales of certain assets may trigger a recapture of capital allowances claimed, while asset purchases may potentially obtain deductions for the financing costs incurred on funds borrowed to finance the acquisition of business assets.

Cross-border payments

Transfer Pricing

Historically, Hong Kong had no statutory transfer pricing rules and the IRD relied on the general provisions in the IRO, case law and (since 2009) practice notes to deal with transfer pricing issues. On July 13, 2018, Hong Kong's transfer pricing regime was enacted to codify and reaffirm the taxpayers' and IRD's common understanding that transactions

between ‘closely connected persons’ (which are typically determined on the basis of participation in the management, control and capital of another or of common participation by/through a third party) must follow the arm’s length principle, consistent with the OECD’s transfer pricing guidelines. The IRD has provided guidance to facilitate taxpayers’ understanding of the specific requirements through practice notes.

Under (transfer pricing) ‘Rule 1’, the IRD is empowered to adjust profits or losses where a transaction (or series of transactions) between related parties (including a Hong Kong resident enterprise and its overseas branch) departs from the transaction(s) that would have been entered into between independent persons, in cases where this gives rise to a potential Hong Kong tax advantage. The burden of proof on whether the amount of a taxpayer’s income or loss stated in its tax return is arm’s length lies with the taxpayer. ‘Rule 1’ applies to transactions for the year of assessment 2018/19 and onwards.

‘Rule 2’ is the effective adoption of the OECD’s authorized approach for attributing profits to a permanent establishment. In this regard, the arm’s length principle also applies to dealings between different parts of an enterprise such as between the non-resident head office and a permanent establishment in Hong Kong. ‘Rule 2’ applies from the year of assessment 2019/20.

It is worth noting that a formal regime for advance pricing arrangements (APAs) has also been established to facilitate taxpayers entering into unilateral APAs or bilateral APAs involving other jurisdictions.

Hong Kong’s transfer pricing documentation requirements are consistent with the OECD’s three-tiered standardized approach which includes the Master File, Local File and CbC report. More specifically, Hong Kong resident ultimate parent companies of multinational enterprises with consolidated revenue over HKD 6.8 billion (i.e. approximately EUR 750 million) in the previous year of assessment, or Hong Kong entities that are nominated as surrogate filing entities, are required to prepare and submit a CbC report to the IRD. A CbC report must be prepared for accounting periods beginning on or after January 1, 2018, in principle, within 12 months after the end of the accounting period to which the report relates.

For Hong Kong taxpayers belonging to a group of which the ultimate parent company is resident overseas and the consolidated revenue exceeds the relevant threshold (stipulated in that jurisdiction’s laws or regulations), the local filing of a CbC report in Hong Kong is not required if: (i) the ultimate parent company’s jurisdiction of tax residence has neither participated in the Convention on Mutual Administrative Assistance in Tax matters nor entered into a DTA or TIEA with Hong Kong; or (ii) the relevant DTA/TIEA between such jurisdiction and Hong Kong does not allow any automatic exchange of information.

CbC reports are not made available to the public. In accordance with the OECD’s Report Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report, the IRD has expressed (in its practice notes) that the Commissioner of Inland Revenue will (only) use the information in a CbC report for: (a) high-level transfer pricing risk assessment; (b) assessment of other BEPS-related risks (including raising enquiries in the course of a tax audit or investigation); and (c) economic and statistical analysis where appropriate.

Withholding Taxes

Under Hong Kong’s tax framework, there is no withholding taxes on dividends or interest, however royalties are subject to withholding tax. Generally, the assessable profits of royalties are 30% times the tax rate, while the two tiered tax profits rate regime applies. As such, accrued profits are taxed at 2.475% or 4.95% for incorporated businesses, and the rate of 2.25% and 4.5% is applied to unincorporated businesses and individuals. The following types of payments are subject to withholding tax:

i. Sums derived from the exhibition or use of cinematograph or television films or tapes, sound recording or advertising material connected with such film, tape or recording which are deemed to arise in Hong Kong because of their exhibition or use in Hong Kong; and
ii. Sums derived from the use of or the right to use a patent, design, trademark, copyright material, secret process or formula or other property of a similar nature which are deemed to arise in Hong Kong because of the use of or the right to use such property in Hong Kong.

A new deeming provision, which aligns the taxation of income from intellectual property with value creation contributions in Hong Kong, applies to any assessment beginning on or after April 1, 2019. Where a person has contributed in Hong Kong to the development, enhancement, maintenance, protection or exploitation of an intellectual property and income is derived by a non-Hong Kong resident that is an associate of that person from the use of or a right to use such intellectual property outside Hong Kong, the part of the income which is attributable to the value

creation contributions in Hong Kong will be regarded as a taxable trading receipt arising in or derived from a trade or business carried on in Hong Kong.

Where a person carrying on a trade or business in Hong Kong has at any point in time wholly or partly owned the intellectual property and the sums accrued royalties is to an associate, the deemed assessable profits are 100% of the royalties received. This is to prevent tax avoidance by entering into arrangements with overseas associates.

Payments of fees for rental or management services are not subject to withholding tax in Hong Kong.

Double Taxation Relief

Hong Kong has a quickly expanding double tax agreements (DTA) network, and also several tax information exchange agreements (TIEA) which have been concluded and are effective. The Hong Kong government aims to expand Hong Kong's DTA network, especially with respect to countries along the so-called 'Belt and Road' business initiative, with a view to bringing the total number of DTAs to at least 50 over the next few years.

Hong Kong does not incorporate limitation of benefits (LOB) clauses in the DTAs that have been concluded so far. Nonetheless, most of the existing DTAs concluded by Hong Kong already contain specific provisions to prevent treaty abuse under specific articles (e.g. those on dividends, interest and royalties), based on whether one of the main purposes of the arrangement or transaction is to obtain treaty benefits. Accordingly, Hong Kong has opted to adopt a principal purpose test only in respect of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting' (MLI), as discussed in more detail below.

In practice, both Hong Kong incorporated entities and foreign-incorporated entities must have an appropriate level of business substance in Hong Kong in order to obtain a Certificate of Resident Status from the Inland Revenue Department. The Certificate of Resident Status should be obtained from the Inland Revenue Department in order to claim benefits as a Hong Kong tax resident under applicable double taxation agreements / DTAs.

Multilateral Instrument

The MLI applies to Hong Kong through the People's Republic of China, and adopts the four minimum standards of the MLI.

Anti-Avoidance

Hong Kong has general anti-avoidance rules ("GAAR") in the IRO, in respect of which transactions which reduce the amount of tax payable and which appear to be artificial or fictitious may be disregarded by the tax authorities in determining the taxpayer's assessable profits, particularly to dissuade the shifting of assessable income from a Hong Kong resident to a closely connected non-resident person.

Furthermore, there are various specific anti-avoidance rules in the IRO.

There is no specific legislation which aims to make special disclosures of avoidance schemes. However, the IRD has expressed its view in practice notes that GAAR will be invoked where taxpayers book profits offshore with a view to avoiding Hong Kong tax. In particular, the IRD pays close attention to transactions where taxpayers have entered into transactions with a closely-connected non-resident person, which would have to be reported in the profits tax return at hand. Upon request by the IRD, taxpayers are obliged to provide information to substantiate claims that the profits in question are not sourced in Hong Kong.

It is worth noting that under the Hong Kong Anti-Money Laundering and Counter-Terrorist Financing Ordinance, 'money laundering' is defined as "an act intended to have the effect of making any property: (a) that is the proceeds obtained from the commission of an indictable offence under the laws of Hong Kong, or of any conduct which if it had occurred in Hong Kong would constitute an indictable offence under the laws of Hong Kong; or (b) that in whole or in part, directly or indirectly, represents such proceeds, not to appear to be or so represent such proceeds".

Under the IRO, 'tax evasion' is an indictable tax offence fulfilling the above 'money laundering' definition, which constitutes a predicate offence for money laundering in Hong Kong: (1) "Any person who willfully with intent to evade

or to assist any other person to evade tax: (a) omits from a return made under this Ordinance any sum which should be included; (b) makes any false statement or entry in any return made under this Ordinance; (c) makes any false statement in connection with a claim for any deduction or allowance under this Ordinance; (d) signs any statement or return furnished under this Ordinance without reasonable grounds for believing the same to be true; (e) gives any false answer whether verbally or in writing to any question or request for information asked or made in accordance with the provisions of this Ordinance; (f) prepares or maintains or authorizes the preparation or maintenance of any false books of account or other records or falsifies or authorizes the falsification of any books of account or records; or (g) makes use of any fraud, art, or contrivance, whatsoever or authorizes the use of any such fraud, art, or contrivance, commits an offence."

Donations

Charitable donations made to approved charitable institutions or trusts of a public character or to the Government of the Hong Kong Special Administrative Region, amounting in aggregate not less than HKD 100 but not exceeding 35% (10% for years of assessment up to and including 2002/03; and 25% for years of assessment 2003/04 to 2007/08) of the adjusted assessable profits before deduction of donations, are allowable for deduction in computing the assessable profits.

Value Added Tax

Currently, Hong Kong does not have a VAT or GST regime.

Payroll taxes

Individuals are subject to salaries tax on income received from an office, employment or pension, net of eligible allowances and deductions, at progressive tax rates ranging from 2% to 17% (and capped at standard rate of 15% on assessable income). Other income such as dividends, interests or capital gains are not subject to tax in the hands of the individuals, however gains from share options related to an office or employment are subject to salaries tax, as are director's fees, bonuses, awards, gratuities or other allowances, perquisite or fringe benefit from employment. Severance payments and long-term service payments to the extent required under the Employment Ordinance are not subject to salaries tax. All income from a Hong Kong employment is regarded as sourced in Hong Kong and subject to salaries tax. Where a person is under a non-Hong Kong employment, there may be potential salaries tax liability on income attributable to services rendered in Hong Kong, as being Hong Kong sourced income from an employment or office.

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