

## **Introduction**

1. This booklet provides a brief explanation of how The Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income (“the Arrangement”) applies to an *enterprise*. For more detailed information, please refer to Departmental Interpretation & Practice Note No 32. This booklet has no legal binding effect and does not affect a person's right of objection or appeal to the Commissioner of Inland Revenue (“the Commissioner”), the Board of Review or the Courts.
  
2. The Arrangement applies to income derived from Hong Kong in any year of assessment commencing on or after *1 April 1998* and to income derived from the Mainland on or after *1 July 1998*.

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## **1 The territorial source principle of taxation**

Hong Kong adopts a territorial source principle of taxation. Only profits which arise in or are derived from Hong Kong are subject to Profits Tax. Profits which are sourced outside Hong Kong are not taxable.

## **2 Personal scope**

The Arrangement applies to a person who is a *resident* of either the Mainland or Hong Kong or is a resident of both.

## **3 Taxes covered**

In the Mainland the Arrangement applies to *Individual Income Tax*, *Foreign Investment Enterprises Income Tax*, *Foreign Enterprises Income Tax* and *Business Tax* (for shipping, air and land transport only). In Hong Kong the Arrangement applies to *Profits Tax*, *Salaries Tax* and tax charged under *Personal Assessment*.

## **4 Enterprise**

The Arrangement does not define the term “enterprise” and it is to be interpreted in accordance with the domestic laws of Hong Kong and the Mainland.

The Mainland regards an enterprise as an economic organization formulated in accordance with the law, and is engaged in production, trading, or other activity for the purposes of gain. It also practises independent business accounting and takes full responsibility for its profits and losses.

Hong Kong regards an enterprise as any activity carried on for business or commercial purposes, such as manufacturing and trading. The Department would regard the term to include a company and any other body of persons.

## **5 Resident**

According to Article 6 of the Arrangement, the term “resident” means any “person” who is *liable to tax* of One Side by reason of his residence, domicile, place of effective management, place of head office or any other criterion of a similar nature in accordance with the laws of the respective Sides. The term “person” is defined to include an individual, a company, and any other body of persons.

### **(1) Resident “individual”**

Please refer to Question 1 in the “Guide For Personal Services”.

### **(2) Resident “company”**

The term “company” means any body corporate or any entity which is treated as a body corporate for tax purposes. Neither the Arrangement nor the Inland Revenue Ordinance (Cap.112) (“IRO”) contains a definition of a “resident company”. Case law has established that a company is resident in Hong Kong if its central management and control is in Hong Kong, i.e., the place where business is being carried on. The issue is purely a question of fact.

### **(3) Resident “body of persons”**

The term “person” in Article 7 also refers to “any other body of persons”. The Inland Revenue Department (“the Department”) regards this as a reference to separate taxing entities such as partnerships. The Department considers a partnership is resident where its effective management and control is located.

## **6** Certification of resident status

When applying for benefits under the Arrangement, an applicant may be required to substantiate his resident status. In such a situation he may apply for a certificate of resident status from the competent authority of the Side where he is resident. If he is unable to produce such a certificate he will be denied the benefits of the Arrangement.

In the case of a Hong Kong resident who is required to substantiate his resident status, the Mainland tax authority will first issue a *referral letter* to the applicant for forwarding to the Department. This, together with a properly completed “*Application for Certification of Resident Status*”, is to be submitted to the Department. The latter form can be obtained from the Department.

The Department will examine the information supplied and if it is sufficient, issue a “*Certificate of Hong Kong Resident Status*”. If the application is rejected, the applicant will be notified accordingly.

## **7** Applying for benefits under the Arrangement

A Hong Kong resident who wishes to obtain the benefits of the Arrangement, including claiming a tax credit, can do so at the time he submits his Profits Tax Return for the relevant year of assessment, or in writing not later than *two years* after the end of the relevant year of assessment. Details should be provided of the income on which relief is being sought, the nature of the tax paid in the Mainland and the amount of tax credit claimed. A copy of the Mainland notice of assessment and documentary evidence that the tax has been paid and is not subject to further adjustment are

required to be submitted with the application. In addition, the applicant must be *resident* in Hong Kong for that year of assessment (see Topic 5 above).

Any *adjustment* to the amount of the income doubly assessed or the amount of tax paid subsequent to the lodgement of the claim *must be notified in writing* to the Department so that corresponding revision can be made.

## **8** Permanent establishment

A permanent establishment is a fixed place of business of a permanent nature where an enterprise carries on the whole or a part of its business activities. The Mainland authority may impose tax on the enterprise if it is held to have a permanent establishment in the Mainland. However, the enterprise will only be subject to tax on only so much of the profit as is attributable to the permanent establishment.

## **9** Features of a permanent establishment

A permanent establishment normally has the following features:

- (1) it is a place of business for the carrying out of business activities;
- (2) it is a fixed place of business of a permanent nature; and
- (3) the enterprise carries on the whole or a part of its business activities at the place of business.

## **10** Activities that do not constitute a permanent establishment

Activities of a *preparatory or auxiliary nature* carried out at a fixed place of business that do not of themselves produce profits will generally not be considered to constitute a permanent establishment. Such activities include:

- (1) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- (3) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (4) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of advertising, or of collecting information, for the enterprise;
- (5) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; or
- (6) the maintenance of a fixed place of business solely for any combination of the activities mentioned in items (1) to (5) above, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

## **11** Representative office

A representative office will *not* be regarded as a permanent establishment and subject to tax if the following conditions are satisfied:

- (1) the activities are for the enterprise itself;
- (2) the activities do not directly generate profits; and
- (3) the functions of the representative office are only of a supportive nature. If the representative office conducts supervisory management functions or manages business operations for the enterprise, its activities would not be regarded as being of the required character. In this event, the representative office would be regarded as a permanent establishment.

## **12** Processing or assembly arrangement with a Mainland entity

When a Hong Kong manufacturing enterprise enters into a processing or assembling arrangement with a Mainland entity, the arrangement may take one of the following forms :-

### (1) *A co-operative processing unit*

The Hong Kong enterprise provides the raw materials, technical know-how, design, training, management and supervision, etc., and the Mainland entity provides the factory premises, the land and labour and is responsible for processing, manufacturing and assembling the goods. In law, the Mainland processing unit is a contractor separate and distinct from the Hong Kong manufacturing enterprise. Profits arising from the

sale of processed goods to the latter are subject to tax in Hong Kong, and the question of apportionment does not arise. However, the Department is prepared to *concede* that the profits in question can, generally, be apportioned on a 50:50 basis (see Topic 20 for the relevant tax credit).

The Arrangement will not disturb this departmental practice.

(2) *An independent sub-contractor*

A Hong Kong manufacturing enterprise, who contracts the processing work to an independent Mainland sub-contractor and pays for the processing on an arm's length basis, is not regarded as having been involved in the processing work. The sub-contracting charges payable to the Mainland sub-contractor will be subject to Enterprises Income Tax in the Mainland. Profits arising from the sale of goods to the Hong Kong manufacturing enterprise are chargeable to Profits Tax.

**13** **A building site, a construction, assembly or installation project**

The IRO imposes tax on profits derived from contracting work carried out in Hong Kong without regard to the duration of the work. However, the Arrangement provides that the profits from such projects will only be subject to tax if the project *lasts for more than 6 months*. Profits from a project that does not last for more than 6 months will not be regarded as constituting a permanent establishment in Hong Kong and profits derived therefrom will not be subject to tax in Hong Kong. A Hong Kong resident with a project in the Mainland will be accorded similar treatment.

## **14 Calculation of the duration of a project**

The period for which a project is carried out is counted from the date the contractor commences work (including all preparatory activities) up until the date of completion of the work and the hand over of the work completed. If the period covers two years, the period is counted on a continuous basis over the years in question. In a case where two or more sub-projects are contracted for at the same site or for the same project, the period is counted from the date of commencement of the first sub-project to the date of completion of the last sub-project. In other words the sub-projects are but part of a single project. However, where the sub-projects are situated at different localities and are contracted for different projects, the respective periods may be counted separately.

## **15 Provision of services by an enterprise**

A Hong Kong enterprise is regarded as having a permanent establishment in the Mainland if it provides services, including consultancy services, through employees or other personnel situated therein. The services have to be furnished for the same project or a connected project for a period or periods *exceeding in the aggregate 6 months* in any 12-month period.

The scope of consultancy services includes:

- (1) improvement of production facilities and products, selection of technical know-how, or enhancement of supervisory and management skills, etc.; and
- (2) the feasibility analysis of investment projects and the selection of design plans.

## **16 Business agent**

### **(1) *Dependent agent***

An agent (acting under the control and leadership of a Hong Kong enterprise) who regularly acts on behalf of that resident in the Mainland and has an authority to conclude contracts (including participation and decision making in the negotiation of the contract terms), will be regarded as a permanent establishment of the Hong Kong enterprise in the Mainland. This is the case even though the agent is not the final signatory to the contract.

### **(2) *Independent agent***

An agent who does not act wholly or almost wholly on behalf of a Hong Kong resident in the Mainland will not be considered to be a permanent establishment of that resident in the Mainland.

## **17 Business profits**

In the Mainland, profits refer to all profits derived by an enterprise directly from its business activities. In Hong Kong, profits refer to the business profits derived by an enterprise and are computed in accordance with generally accepted accounting principles and the provisions of the IRO.

## **18** **Passive income**

The chargeability of certain items of passive income, such as gains from immovable property, rent and gains of a capital nature, will depend on whether the income is derived from a business carried on through a permanent establishment or a fixed base. Thus, if the derivation of the above items of income is substantially connected with a permanent establishment or a fixed base situated in the Mainland, they would be regarded as part of the business profits of the permanent establishment and be subject to Enterprises Income Tax. If this is not the case the income will be subject to Withholding Tax.

## **19** **Shipping, air and land transport**

### (1) *Shipping Transport*

The Arrangement provides that Hong Kong has the right to tax a Hong Kong resident on profits derived from its shipping business and will be exempt from Enterprises Income Tax and Business Tax in the Mainland.

It should be noted that in calculating the assessable profits of a ship-owner carrying on business in Hong Kong, section 23B of the IRO already provides that sums derived from relevant carriage shipped aboard a Hong Kong registered ship and towage operation undertaken by it at or from any location within the waters of Hong Kong and proceeding to sea are exempt from Profits Tax and that one half of any sums derived from charter hire in respect of the operation of a ship navigating between any location within the waters of Hong Kong and any location within river trade waters are also tax exempt. These exemptions still apply after the Arrangement has come into effect.

(2) ***Air Transport***

The Arrangement provides that Hong Kong has the right to tax a Hong Kong resident on profits derived from its air transport business and will be exempt from Enterprises Income Tax and Business Tax in the Mainland.

However, in accordance with section 23C(2A) of the IRO sums derived from any relevant carriage and charter hire from the Mainland derived by a Hong Kong resident, that are exempt from tax in the Mainland under the Arrangement, are included as “relevant sums” in calculating profits chargeable to tax in Hong Kong.

(3) ***Land Transport***

The Arrangement provides that Hong Kong has the right to tax a Hong Kong resident on profits derived from its cross-border land transport business and will be exempt from Enterprises Income Tax and Business Tax in the Mainland.

A cross-border land transport business between the Mainland and Hong Kong usually takes the form of a co-operative enterprise. Typically the Hong Kong resident will make his investment in the form of vehicles and capital. The Mainland resident will be responsible for the application of permits and licences, tax compliance and other management services. This kind of co-operative enterprise is regarded as a joint business of cross-border transport operated by a resident of the Mainland and of Hong Kong. The share of revenues and profits derived by the Hong Kong resident will be exempt from tax in the Mainland and subject to Profits Tax in Hong Kong.

## **20 Tax credit**

In the case of a Hong Kong resident deriving income that is subject to tax in Hong Kong, any tax paid in the Mainland in respect of that income shall be allowed as a credit against the Hong Kong tax payable on that income. The amount of the tax credit cannot exceed the amount of tax payable in respect of that income, computed in accordance with the provisions of the IRO. The total amount of the tax credit to be allowed for a year of assessment cannot exceed the total Hong Kong tax payable for that year of assessment. In the case where the Hong Kong tax payable for a year of assessment is “NIL”, e.g., in a loss situation, a tax credit is not allowable for any Mainland tax paid nor can the Mainland tax be carried forward and allowed as a tax credit in a subsequent year of assessment.

In the case of a Hong Kong manufacturing enterprise whose profits are apportioned on a 50:50 basis and where the Mainland regards more than one-half of such profits as derived from the Mainland, a tax credit will only be allowed in respect of the tax paid in the Mainland on those profits in excess of one half of the total profits.

## **21 Consultation**

The competent authorities of the Mainland and Hong Kong shall endeavour to resolve by consultation any difficulties or doubts arising in relation to the interpretation or application of the Arrangement.

Where a Hong Kong resident considers that an assessment issued by the Mainland authority is not in conformity with the provisions of the Arrangement, he should first lodge his objection with the Mainland authority in accordance with the procedures and time limits provided by the Mainland tax laws. In the event that the claim cannot be settled unilaterally or is not dealt with expeditiously through normal procedures, the taxpayer may apply through the Department to have the problem dealt with through mutual consultation.

**22 Enquiries**

For enquiries on matters in relation to the Arrangement, please write to:

The Senior Assessor (Double Taxation)  
Inland Revenue Department  
GPO Box 132  
Hong Kong