

HONG KONG TAX ALERT

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Tax Residency Certificate requirements

Summary

- The IRD views its more stringent approach to granting TRCs as a measure to prevent treaty abuse and for Hong Kong to be regarded as a responsible treaty partner.
- The IRD clarified its view that “beneficial ownership” is a pre-requisite for granting the preferential tax treatment in the passive income articles of a DTA. Accordingly, if a company is unable to meet all the criteria of the relevant article of the DTA, including the requirement to be the beneficial owner of the income, the IRD may refuse to issue a TRC.
- Taxpayers need to understand the IRD’s current practices and requirements before submitting their applications for TRCs, to ensure a successful and efficient process.

With Hong Kong continuing to expand its double tax treaty (DTA) network, an increasing number of taxpayers have been applying to the Inland Revenue Department (IRD) for Hong Kong tax residency certificates (TRCs) in order to claim tax benefits available under applicable DTAs. However, the IRD’s attitude towards these applications has changed over recent years and has become notably more stringent. Taxpayers need to understand the IRD’s current practices and requirements before submitting their applications for TRCs, to ensure a successful and efficient process.

Tax residency requirements under Hong Kong’s DTAs

In the DTAs entered into between Hong Kong and its treaty partners, a Hong Kong resident company is defined as:-

- A Hong Kong incorporated company; or
- A company incorporated outside Hong Kong that is managed or controlled in Hong Kong (or “normally” managed or controlled in Hong Kong, depending on the particular wording of the DTA).

Based on the above definition, being a Hong Kong incorporated company alone should be sufficient for a company to qualify as a Hong Kong tax resident for DTA purposes. However, the IRD generally requires even a Hong Kong company to have its management or control “normally” exercised in Hong Kong before it will agree to issue a TRC.

It is important to note that the tax landscape has changed in the past few years. Many jurisdictions have been introducing new measures to implement the various Base Erosion and Profit Shifting (BEPS) Action Plans released by the OECD seeking to address international tax issues such as treaty abuse, beneficial ownership and the inherent conflict between source-based and residency-based taxation. Accordingly, the IRD views its more stringent approach to granting TRCs as a measure to prevent treaty abuse and for Hong Kong to be regarded as a responsible treaty partner.

Place of management and control

The IRD has acknowledged that whether a company is “normally managed or controlled” in Hong Kong is a question of fact, depending on the particular circumstances of each case. Companies carrying on an active business in Hong Kong should not encounter difficulties in demonstrating that their management and control are exercised in Hong Kong. However, for companies which only derive passive income, it may not be that easy. Generally, in determining the place of management or control, we have observed that the IRD focuses on the following areas:-

- Composition of board – the nationality of the board members does not usually matter. Rather, the IRD places emphasis on whether any of the board members has a place of residence in Hong Kong.
- Board meetings – the IRD generally regards the board as the body exercising management or control of the company. Areas examined by the IRD include (1) where the board meetings are held; (2) what is discussed and resolved; and (3) how the resolved matters are implemented or executed. The IRD tends to focus on the physical presence by board members to determine where the meeting is held and, in some cases, will also look at where the preparation for the meeting is carried out.
- Employees – apart from the board members, the IRD looks at whether the applicant has employees in Hong Kong and, if so, what are the duties of those employees. Less emphasis is normally placed on employees who are clerical or administrative.
- Establishment – the IRD generally expects the applicant to have a physical office / fixed place of business and a bank account in Hong Kong.

The latter two points illustrate that the IRD may request documentation to support not only that the management or control of the relevant company are exercised in Hong Kong but to also provide evidence that there is sufficient business substance in Hong Kong.

DTA benefit being sought

Before assessing the applicant’s tax residence status, the IRD will first establish what DTA benefit the applicant is seeking. In its 2016 annual meeting with the Hong Kong Institute of Certified Public Accountants, the IRD clarified its view that “beneficial ownership” is a pre-requisite for granting the preferential tax treatment in the passive income articles of a DTA. Accordingly, if a company is unable to meet all the criteria of the relevant article of the DTA, including the requirement to be the beneficial owner of the income, the IRD may refuse to issue a TRC.

It is interesting to note that the IRD is only prepared to issue a Hong Kong tax residency certificate for a year in which the applicant has recognised the relevant income (i.e., dividends, royalties or capital gains) qualifying for a DTA benefit. That means that there should be a genuine need to present the Hong Kong tax residency certificate to the competent authority of the DTA partner.

Interestingly, the IRD also said that, if it denies a TRC request, no judicial review process is available to the applicant. Its reasoning was that the statutory provisions of the Inland Revenue Ordinance do not concern TRCs and, therefore, issuing TRCs is an administrative procedure only. However, this position is by no means certain. After all, the essence of juridical review is to challenge administrative decisions by government officials who act without any arguably reasonable basis.

Validity of a Hong Kong TRC

A Hong Kong TRC is valid for one year and renewed on a calendar year basis, with the exception of TRCs issued under the Hong Kong – PRC DTA. Under the terms of the administrative agreement with the Mainland in June 2016, a Hong Kong TRC issued for a calendar year may serve as a proof of the Hong Kong tax residence status for that particular year as well as the succeeding two years. In practice, where the IRD has issued a TRC for the purpose of the Hong Kong – PRC DTA in a particular year, it will refuse to issue another TRC for the subsequent two years, unless the applicant can demonstrate a compelling reason for such a need.

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