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# Tax Analysis

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## Hong Kong SAR Signs Comprehensive Agreement for the Avoidance of Double Taxation with Canada

Hong Kong and Canada signed a Comprehensive Agreement for the Avoidance of Double Taxation (hereinafter "CDTA") on 11 November 2012 that is expected to result in closer economic cooperation and the promotion of greater synergies. This is Hong Kong's 26th comprehensive agreement for the avoidance of double taxation; Canada currently has 90 treaties in force and has signed a number of others.

Negotiation of the CDTA was initiated in June 2011 and has been highly anticipated by communities in both Canada and Hong Kong. Its swift conclusion and the visit by Canada's Prime Minister to witness the signing ceremony signify the importance being placed on further strengthening the relationship between the two jurisdictions. The CDTA, in conjunction with domestic laws, offers tax benefits that are generally more attractive than benefits in Canada's treaties with its other major Asian trading partners such as China, India, Japan, Korea and Singapore. This should further Hong Kong's objective of being the gateway between Canada and the Asia Pacific region, as well as Canada's objective of fostering trade between Canada and the region.

**Key features**

A key aspect of the signing of the CDTA for Canadian companies with Hong Kong subsidiaries is the opportunity for such subsidiaries to earn “exempt surplus” in respect of their active business earnings. Active business income earned in a treaty country is included in exempt surplus and can be repatriated free of additional Canadian tax. Once the CDTA is ratified, a foreign affiliate resident in Hong Kong will be able to earn exempt surplus rather than taxable surplus retroactively beginning with its taxation year that includes 11 November 2012.

Generally speaking, the CDTA is in line with the OECD model treaty. Key features of the agreement include:

- *Dividends* – Reduction of Canadian withholding tax to 5% where the beneficial owner is a corporation that controls directly or indirectly 10% of the voting shares of the payer company. There is no dividend withholding tax in Hong Kong.

- *Interest* – Reduction of Canadian withholding tax to 10% for non-arm's length interest. The withholding tax rate for arms' length interest is generally 0% (which corresponds to Canadian domestic tax legislation). There is no withholding tax on interest in Hong Kong.
- *Royalties* – Reduction of Canadian withholding tax to 10%. The Hong Kong domestic rate of 4.95% still should apply to royalties paid to Canadian residents as it is lower than the 10% rate in the CDTA.

The CDTA may increase the attractiveness of Hong Kong as a holding company location for investments in Canada, as compared to other jurisdictions. Canadian investors will benefit from Hong Kong's expanding network of tax agreements, which includes a favorable arrangement with China.

A comparison of various withholding tax rates under the CDTA and domestic law is set out below:

| | Canada domestic | Hong Kong domestic | Canada-Hong Kong CDTA | Canada-China treaty | Canada-Singapore treaty |
|---|---|---|---|---|---|
| **Dividends** | 25% | 0% | **5%**[1] | 10%[2] | 15% |
| **Interest** | 0%/25% | 0% | **10%** | 10% | 15% |
| **Royalties** | 25% | 4.95%[3] | **10%** | 10% | 15% |

With regard to the taxation rights for capital gains derived from the disposal of shares in a company resident in the other jurisdiction, the CDTA generally follows the OECD model and only allows the jurisdiction in which the alienator is resident to tax these capital gains, except in certain circumstances. In particular, gains derived from the disposition of immovable property can be taxed in the other jurisdiction, including gains derived from the disposal of shares in a company that derives more than 50% of its value, directly or indirectly, from immovable property situated in the other jurisdiction. Unlike treaties concluded by Canada with certain countries such as Luxembourg and the Netherlands, there is no exception provided for situations where the value of the shares is derived principally from Canadian immovable property in which the business of the company is carried on.

**Other notable provisions**

***Anti-abuse and limitation of relief measures*** - Following what appears to be a general trend in agreements/treaties signed by Hong Kong and Canada (for Hong Kong, these include agreements signed with Indonesia, the Netherlands and the U.K.; for Canada, these include treaties signed with Colombia, New Zealand, Poland, etc.), the CDTA contains "anti-treaty" shopping measures that seek to deny benefits under the dividend, interest and royalty articles for taxpayers where "one of the main purposes" in structuring a particular transaction is to obtain benefits under the relevant article.

Further, article 26(2)(b) enables either jurisdiction to apply the "provisions of its law which are designed to prevent tax avoidance, including measures relating to thin capitalization." This provision presents an overarching curb on potential abuse of the CDTA by broadly allowing either jurisdiction to apply its domestic laws in counteracting potential abusive transactions involving the CDTA.

In addition, article 26(4) contains a provision that is not commonly seen in Hong Kong's or Canada's agreements/treaties. It states:

> "Where under any provision of this Agreement any income is relieved from tax in a Party and, under the law in force in the other Party a person, in respect of that income, is subject to tax by reference to the amount thereof that is remitted to or received in that other Party and not by reference to the full amount thereof, then the relief to be allowed under this Agreement in the first-mentioned Party shall apply only to so much of the income as is taxed in the other Party."

Broadly speaking, the provision seeks to limit benefits under the CDTA to amounts that are remitted to, or received in, a partner jurisdiction where that jurisdiction only taxes such income on a remittance or receipt basis under its domestic

[1] The dividend withholding tax rate of 5% under the CDTA applies if the beneficial owner is a company that controls directly or indirectly at least 10% of the voting power of the company paying the dividends.
[2] The dividend withholding tax rate of 10% under the treaty applies if the beneficial owner is a company that owns at least 10% of the voting stock of the company paying the dividends.
[3] The 4.95% rate applies provided the royalties are not paid to a related party, or if paid to a related party, the licensed intellectual property has never been owned in whole or in part by a person carrying on business in Hong Kong.

tax law. Neither Canada nor Hong Kong taxes income on a remittance or receipt basis and, therefore, this provision should have no current application. At present, the application of this provision to income received by Hong Kong companies appears to be academic. Regardless of whether income is remitted to or received in Hong Kong, income derived by taxpayers carrying on business in Hong Kong would be subject to Hong Kong tax if such income is Hong Kong sourced, is revenue in nature and is not otherwise exempt from tax in Hong Kong. For example, Hong Kong companies would prima facie be entitled to the lower rate of Canadian withholding tax on dividends receivable from Canadian companies even though the dividends are not subject to tax in Hong Kong. The fact that the dividends are not subject to tax in Hong Kong does not depend on whether or not the dividends are remitted to or received in Hong Kong.

*Exchange of information* - Critical to the conclusion of the CDTA were the exchange of information article and the related protocol. The CDTA specifically provides that information communicated will be treated as secret and that it can be used only for the purposes provided for in the CDTA. In addition, a protocol to the CDTA states that it is understood that:

- The article does not require the exchange of information on an automatic or a spontaneous basis;
- Information exchanged shall not be disclosed to any third jurisdiction for any purpose; and
- A party may only request information relating to taxable periods for which the CDTA has effect for the party.

While the adoption of the 2004 version of the OECD model standard exchange of information article has enabled Hong Kong to negotiate and sign many agreements since 2010, the Hong Kong Inland Revenue Department also had issued Departmental Interpretation and Practice Notes No. 47 (DIPN 47) to assuage taxpayers' concerns about their privacy rights. DIPN 47 sets out the safeguards put in place to protect confidentiality and privacy rights and its administrative practice in relation to the exchange of information with Hong Kong's agreement partners.

### Effective date

The Canadian withholding tax benefits under the CDTA will come into effect as from 1 January following the year in which both jurisdictions exchange completed instruments of ratification. If both jurisdictions can complete these procedures in 2012, the CDTA would be effective as early as 1 January 2013. Otherwise, for Canadian withholding tax purposes, it will be effective on 1 January of a later year. All other Canadian benefits under the CDTA will be effective for taxation years beginning on or after 1 January of the calendar year following that in which the CDTA comes into force, with the exception of certain provisions concerning shipping and air transport.

As regards Hong Kong, the CDTA will be effective as early as the year of assessment 2013/14 if it is ratified during 2012. Otherwise, it will take effect only for subsequent years of assessment, depending on the calendar year in which the agreement is ratified.

### Where to go from here?

For Canadian taxpayers expanding into Asia, the CDTA is a welcome development. As noted above, with the CDTA in place, dividends from active business earnings from a Hong Kong subsidiary generally should become fully deductible and, hence, not subject to Canadian tax. This is a key benefit to many Canadian multinationals with or contemplating setting up operations in Hong Kong that may wish to repatriate the earnings to Canada.

Many Canadian companies that are considering the Asia Pacific marketplace now have a more robust and efficient basis from which to build. For many, Hong Kong is a natural regional holding company location, and this CDTA provides significant tax efficiency in that regard.

For Asian investors, particularly Chinese investors investing into Canada, the CDTA also provides a tax efficient platform from which to make Canadian investments. While Hong Kong is already a natural business platform for many Chinese companies, the CDTA may enhance opportunities. For example, given that the CDTA offers a more favorable dividend withholding tax rate of 5% than the 10% available under the Canada-China treaty, Chinese companies may consider holding their Canadian investments through a Hong Kong holding company rather than directly in order to achieve more tax efficient profit repatriation. Nevertheless, the anti-avoidance rules under the CDTA and Chinese domestic general anti-avoidance and beneficial ownership rules should be carefully considered.

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