

# Hong Kong Hong Kong



# Inbound Investment Inbound Investment

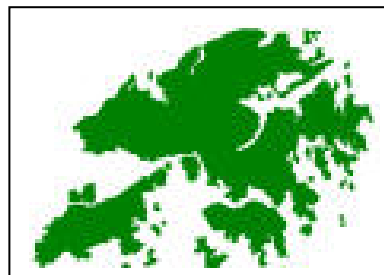
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## I. INTRODUCTION

Hong Kong adopts a **territorial tax system** under which only Hong Kong sourced income is chargeable to tax. Therefore, it is very important to identify the source of income before determining the tax liabilities of a taxpayer in Hong Kong.



## II. PROFITS TAX

### 1. Scope of Charge

- 1.1 Under the territorial tax principle, only profits derived from a trade, profession or business in Hong Kong are liable to Profits Tax. Hong Kong Inland Revenue Department (“IRD”) will generally consider the following two issues:-

**What** the taxpayer has done to earn the profits in question; and  
**Where** he has done it.

The tax rate of corporation is 17.5% and the tax rate of unincorporated business is 15.5% for the year ending on 31 March 2004.

### 1.2 Chargeability to Profits Tax of Typical Income

Type of income	Hong Kong Sourced and Taxable If
1. Trading	Either the sale or purchase contract is negotiated, concluded and executed in HK
2. Manufacturing	The goods are manufactured in HK
3. Rental income	The letting property is located at HK
4. Service income	Services are performed in HK
5. Commission income	The activities which give rise to the income are conducted in HK
6. Interest income	The loan is first made available to the borrower in HK (except financial institution)
7. Royalty income	Please refer to paragraph 7 below

## 2. Test of Residence

Since Hong Kong adopts the territorial tax regime, no distinction is made between resident and non-resident. Profits Tax liability of a taxpayer is determined according to the source of income (i.e. the place where the income is actually derived), not residency.

### 3. Branch vs. Subsidiary

- 3.1 There is basically no difference in Profits Tax liabilities on inbound investment made through a branch or a subsidiary. They are subject to the same sets of business regulations and taxes.
- 3.2 The main cost saving from operating as a branch, as opposed to a subsidiary, is that capital duty of 0.1% on authorized share capital is not required.
- 3.3 From commercial and legal perspectives, a subsidiary may have certain advantages over a branch. Since subsidiary is a separate legal entity, its shareholders enjoy limited liabilities. Another advantage of operation through a subsidiary is that reorganization of group activities and tax planning is often easier.
- 3.4 Branches of overseas companies will be chargeable to Profits Tax as follows:
- i. If the accounts of a Hong Kong branch are kept in such a way that its true profits arising in or derived from the territory can be readily ascertained, the IRD will compute its tax liability by reference to the branch accounts.
  - ii. If no accounts are prepared which, in the opinion of the IRD, disclose the true profits of the Hong Kong branch, the IRD will compute its Profits Tax liability by reference to the company's total profits. That is;  
  
$$\left( \text{Sales in HK} / \text{Company's Total Sales} \right) \times \text{Company's Total Profits}$$
  - iii. If the IRD considers that above two methods are impracticable or inequitable, it may compute the assessable profits of the Hong Kong branch on a "fair" percentage of sales in Hong Kong.

### 4. Thin Capitalization Rules

- 4.1 Hong Kong has no debt-equity restrictions (except for certain special business such as banking and insurance). A Hong Kong incorporated company therefore can be financed through any ratio of share capital to debt.
- 4.2 If a Hong Kong company borrows loan in foreign currency, any exchange gain or loss so incurred may be taxable or deductible, provided that the loan is used as part of the company's working capitals to generate taxable profits.
- 4.3 Loan interests paid to a related company is tax deductible if the recipient is subject to Profits Tax in Hong Kong on the interest income earned. Accordingly, interests paid to an overseas parent company will not be deductible if the interest income in the hands of the parent company will not be chargeable to Profits Tax.

## 5. Tax Losses

- 5.1 Taxpayers who have sustained losses in any trade, profession or business are entitled to carry forward the losses to set-off against profits in subsequent years of assessment. Tax losses cannot be carried backward.
- 5.2 The IRD may disallow the setting-off of losses sustained by a corporate taxpayer if the company has changed its shareholding in a year and the sole or dominant purpose of the change is to utilize the losses to obtain a tax benefit.

## 6. Transfer Pricing Issues

- 6.1 Inter-company service fee (e.g. management fee, training fee, administration fee etc.) within a group is tax deductible if the following conditions are satisfied: -
- i. it is incurred for earning the company's taxable profits; and
  - ii. the amount involved is reasonable (i.e. on arm's length basis).
- 6.2 If a Hong Kong resident carries on business with a closely connected non-resident and the business is arranged such that the Hong Kong resident produces no profits or less than the ordinary profits that could be expected to be sourced in Hong Kong, the business of the non-resident is deemed to be carried on in Hong Kong. The non-resident person will be chargeable to tax on the earned profits in the name of the Hong Kong resident.
- 6.3 In completing the annual profits tax return, Hong Kong resident has to disclose the following information: -
- i. whether Hong Kong resident sells any goods or provide any services in Hong Kong on behalf of a non-resident person;
  - ii. whether Hong Kong resident receives, as agent, on behalf of a non-resident person, any other trade or business income arising in or derived from Hong Kong;
  - iii. whether Hong Kong resident makes payments to a non-resident person for the use of any of the intellectual or moveable property;
  - iv. whether Hong Kong resident carries on business with a closely connected non-resident person;
  - v. whether Hong Kong resident makes payment of any fee to a closely connected non-resident person;
  - vi. amount of income received from closely connected non-resident persons; and
  - vii. amount of fees paid to closely connected non-resident persons.

## **7. Withholding Tax Issues**

### **7.1 Dividend Income**

Since dividend income received by non-resident individual or corporate shareholders from a Hong Kong company is exempted from Profits Tax, the company is not required to withhold tax for its shareholders.

### **7.2 Royalty or License Fee Income**

Non-resident receiving royalty (or license) fee from a taxpayer for the use of an intellectual property (e.g. patent, design, trademark, copyright, secret formula etc.) in Hong Kong is subject to Profits Tax notwithstanding that the non-resident does not carry on a business in Hong Kong.

The Hong Kong taxpayer is required to withhold Profits Tax for the non-resident recipient of the royalty fee. The assessable profit is equal to:-

- i. 30% of the sum if the IRD is satisfied that no person carrying on a trade, profession or business in Hong Kong has, at any time, wholly or partly-owned the intellectual property; or
- ii. 100% of the sum if the above condition is not satisfied.

## **8. Tax Incentives**

8.1 Interest income derived from any deposit placed in Hong Kong with an authorized financial institution is exempt from profits tax.

8.2 Capital expenditure incurred on acquiring prescribed fixed assets (computer hardware and software, and manufacturing plants and machinery) is eligible to claim full tax deduction in the year of acquisition.

8.3 Capital expenditure on refurbishment of business premises can be amortized over a period of five years of assessment at the rate of 20% per annum.

8.4 Profits derived by a professional reinsurer from the business of reinsuring offshore risks will be entitled to a 50% reduction in Profits Tax rate.

8.5 Profits derived from qualified debt instruments with a maturity period of three years will also be entitled to a 50% reduction in Profits Tax rate and full exemption will be granted to certain qualified debt instruments having a maturity period of seven years or more.

## 9. Double Tax Treaties

Hong Kong has not entered into comprehensive double taxation agreements with other countries. Please note that because of the territorial tax system, income derived by a company from overseas will not generally suffer double taxation in Hong Kong. Nevertheless, Hong Kong government does recognize that there are merits in concluding double taxation agreements with her trading partners, particularly in aviation and shipping industries. Hong Kong government therefore has reached double taxation relief arrangements with the following countries in respect of international shipping and airline income:-

Name of country	Airline	Shipping
Bangladesh	Y	N
Belgium	Y	N
Canada	Y	N
Denmark	Y	N
Estonia	Y	N
Germany	Y	Y
Israel	Y	N
South Korea	Y	N
Mauritius	Y	N
Netherlands	Y	Y
New Zealand	Y	N
Norway	Y	N
People's Republic of China*	Y	Y
Russian Federation	Y	N
Sweden	Y	N
United Kingdom	Y	Y
United States of America	N	Y

Y- Arrangement made      N – No arrangement made

\* Apart from airline and shipping income, Hong Kong entered into an arrangement with the Mainland China on 11 February 1998 to avoid double taxation on the following income:

- i. business profits of an enterprise having a permanent establishment in China;
- ii. shipping, air and land transport income; and
- iii. personal services income.

## 10. Other Taxes

There is no capital gain tax, dividend tax, sales tax, value-added tax nor fringe benefit tax in Hong Kong.

### III. INDIVIDUAL TAX

#### 1. Scope of Charge

1.1 Individuals are chargeable to Salaries Tax on any income derived from an office, employment or pension in Hong Kong.

#### 1.2 Chargeability of Typical Income

	Type of income	Hong Kong Sourced and Taxable If
1.	Office income (e.g. director's fee)	The central management and control of the company holding the office are exercised in HK
2.	Employment income	Please refer to Appendix for details
3.	Pension income	Pension is arising in or derived from HK

#### 2. Test of Residency

Same as Profits Tax, as Hong Kong adopts the territorial tax principle, an individual's place of residence is irrelevant for considering his Salaries Tax liabilities in Hong Kong. Rather, the source of income (i.e. the place where the income is actually derived) is the determining factor.

#### 3. Tax Rates and Relief

3.1 There are two methods for calculating the Salaries Tax payable by an individual:-

i. Progressive tax rates on the individual's net chargeable income.

Net chargeable income ("NCI")		2003/04 tax rates	
HK\$		HK\$	%
0	-	32,500	2
32,501	-	65,000	7.5
65,001	-	97,500	13
97,501		or above	18.5

Notes:

a.  $NCI = (\text{Taxable Income} - \text{Allowable Deductions}) - \text{Personal Allowances}$

b.  $\text{Salaries Tax Payable} = NCI \times \text{Applicable Tax Rates}$

ii. Standard rate of 15.5% on the individual's chargeable income (taxable income less allowable deductions).

The IRD will calculate the tax liability for the taxpayer and automatically select the rate that will result in a lower tax charge.

### 3.2 Major Tax Relief

- i. Personal allowances
- ii. Self-education expenses
- iii. Charitable donation
- iv. Home loan interest
- v. Elderly residential care expenses
- vi. Contributions to recognized retirement schemes

### 3.3 Strict requirements applied on deduction of other outgoings and expenses.

## 4. Accrual Basis vs. Cash Basis

Individual is chargeable to Salaries Tax on the actual income earned in a year of assessment (i.e. year ended 31 March) with a charge also made for Provisional Salaries Tax in the same year.

## 5. Fringe Benefits from Employment

5.1 Fringe benefits received by an employee in connection with his employment is generally subject to Salaries Tax.

5.2 Non-taxable fringe benefits include:

- i. Provision of company car to employees for business and non-business use.
- ii. Provision of free medical insurance policy to employees.
- iii. Provision of interest-free or low interest loans to employees.

## 6. Income Received by Overseas Entertainer and Sportsman

6.1 An overseas entertainer or sportsman who performs services in Hong Kong will be assessed to Profits Tax (not Salaries Tax) under the name of the Hong Kong resident who makes payment to him.

6.2 The Hong Kong resident should withhold tax on the basis that assessable profits represent two-thirds of the gross proceeds. In other words, a deduction for expenses equal to one-third of the gross proceeds is automatically allowed by the IRD in computing the assessable profits of the non-resident entertainer or sportsman.

**IV. APPENDIX - CHARGEABILITY OF EMPLOYMENT INCOME**

