Hong Kong as an investment holding company location for investments into the Mainland China

[18 Apr. 2008 Issues 8]

Hong Kong business environment

Hong Kong, strategically located in central East Asia, is a natural gateway to the Mainland China. With rapid growth of China as its hinterland, Hong Kong, over the past decade since its sovereign changeover, continues its status as an international finance center, leading business and trade hub in the region. Built historically on free market economy, Hong Kong has developed into a contemporary international business platform.

As one of the most premier international financial centers, Hong Kong acts as a favored conduit for foreign direct investments into China. With well development in the past decades, Hong Kong financial specialists are managing risks well in respect of investments into China.

Further, the Mainland and Hong Kong Closer Economic Partnership Arrangement ('CEPA'), the first free trade agreement ever concluded by the governments of China and Hong Kong, signed on 29 June 2003, provides the vast opportunities for Hong Kong goods and services and enhances the close economic cooperation and integration between the two places.

CEPA brings with new business opportunities to China, Hong Kong and foreign investors. By establishing business in Hong Kong, foreign investors would enjoy the CEPA benefits and tap in the opportunities of the China market.

Hong Kong has a comparably simple tax system with low tax rates. Under the current tax laws, there are three direct taxes, they are: Profits Tax, Salaries Tax and Property Tax. Persons carrying on any trade, profession or business in Hong Kong are chargeable to tax on all profits arising in or derived from Hong Kong.

Taxation of investment-related income

Currently, the corporate Profits Tax rate is 17.5% (16.5% from the next financial year). Dividend income and capital gains are not subject to Profits Tax, and no withholding tax is imposed on dividends and interests paid from Hong Kong investments.

Double taxation arrangement between China and Hong Kong

On 30 January 2008, Chinese government and the government of Hong Kong signed the Second Protocol (the 'Protocol') to the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (the 'DTA').

The DTA broadens the coverage of all taxes on income in previous arrangements, in terms of elements of income, comprising taxes on income from movable and immovable property and taxes on capital appreciation.

Withholding taxes on indirect income.

DTA covers certain indirect income with a comparison of DTA benefits of investing into China through various holding jurisdictions as follows.

	Hong Kong	Barbados	Mauritius
Dividends	5% / 10%	5%	5%
Royalties	7%	10%	10%
Interests	7%	10%	10%
Capital gains on shares	0% / 10%	0%*	10%/0%

* The Chinese government will renegotiate its treaty with Barbados resulting in changes in the capital gain clause.

Foreign investors should be aware that Hong Kong investors, through DTA, enjoy more favorable or preferential tax treatments as compared with other double taxation treaties signed between China and other countries.

Capital gains

Under the DTA, any capital gains derived from the alienation of shares in a Mainland company the assets of which are comprised, directly or indirectly, mainly (not less than 50%) of immovable property situated in China, within 3 years prior to the transfer, are taxable.

This provision basically facilitates those investors with their core investments in China not related to property developments that capital gains are exempted from China tax.

Further, any capital gains derived from the alienation of not less than 25 per cent equity shares in a Mainland company, which is not an Immovable Property Holding Company, at any time during a 12-month period prior to the transfer, are taxable.

This provision basically facilitates those passive investors in China that capital gains are exempted from China corporate income tax.

The above provisions shall affect Hong Kong residents' interests only, as Hong Kong does not charge any capital gain tax, whether Hong Kong residents or Mainland residents.

The relevant capital gains are subject to 10 per cent withholding taxes in China.

Tax treaty network

Hong Kong has only 4 DTAs – China, Thailand, Belgium and Luxembourg, compared to Barbados with 15 DTAs plus the Caricom treaty, Mauritius with 32 DTAs etc.

Although Hong Kong has a poor treat treaty network, foreign investors could mitigate by interposing other jurisdictions in a chain of offshore entities. However, some jurisdictions might include certain clauses in their DTAs or domestic legislations precluding from treaty shopping. Foreign investors should be aware that the structure should be well planned to address the issues, and it is important to look at the overseas company structure from both a taxation and an operational point of view.

In order to be competitive as one of the most preferred holding company locations, Hong Kong is eager to expand its DTA networks.

Hong Kong as preferred investment holding location

The tax rates under the DTA between China and Hong Kong compare as favorable as any other jurisdictions, except for capital gain tax on investments through Barbados holding. Further, having ongoing implementation of CEPA, foreign investors will simply establish some business setup in Hong Kong, and enjoy the CEPA benefits and tap in the opportunities in the China market. Additionally, the preferential China withholding tax rate of 5% can be offset against Hong Kong profits taxes under the DTA. Given Hong Kong's advantageous geographical location, Hong Kong has a clearly comparable advantage as a holding jurisdiction for investing into China.