Why do you need a HK offshore structure when you invest in China?

Description

Chinese official statistics on foreign investment in China have indicated that Hong Kong has been the biggest source of inbound foreign investment in the mainland China.

But why is it Hong Kong?

In addition to the common advantages of having an offshore structure (an SPV or a pass-through entity), namely, easier transfer of equity interests in the Chinese entity, better financing access and higher appraisal of Chinese assets, the decisive factor for considering Hong Kong over other offshore hotspot like Cayman and BVI is the income tax favorable treatment made available to HK by the mainland China, a unique advantage enjoyed only by Hong Kong.

Favourable Tax Treatment

China mainland has entered into an arrangement with Hong Kong Special Administrative Region for purpose of avoiding double taxation on income under which individuals and companies in Hong Kong are made available with a series of favorable tax treatments, in particular, in regard of dividends received by residents of one party from the companies in the other party.

Section 10 of the Arrangement provides:

> I. Dividends paid by a company of one party to a resident of the other party may be taxed in the other party;
>
> II. However, such dividends may also be taxed in the party of which the company paying the dividends is a resident and according to the laws of that party, but if the beneficial owner of the dividends is a resident of the other party, the tax so charged shall not exceed:
>
> (a) 5 per cent of the gross amount of the dividends if the beneficial owner holds directly at least 25 per cent of the capital of the company paying the dividends;
>
> (b) 10 per cent of the gross amount of the dividends in all other cases.

Literally, it can be inferred that compared with investors from places other than Hong Kong, investors from Hong Kong are subject to only half the tax burden imposed on dividends received from companies in mainland China, namely, 5% of gross dividends. Under current Chinese enterprise income tax laws and tax treaties with most foreign states, dividends received by foreign companies from their invested entities in China are levied with a 10% income tax rate.

In addition to favorable tax treatment accorded to dividends received by Hong Kong Residents, other types of income derived from China such as interest and royalties are generally imposed with a lesser income tax rate of 7% compared with otherwise 10% tax rate applicable to non-HK residents.

Beneficial Owner

The term of “beneficial owner” is very important in application and understanding of the rules discussed above.

However, it is a tough tast to define “beneficial owner”. China State Administration of Taxes has issued two notices guiding how to dertermine “beneficial owner”.

In essence, to be regarded as a “beneficial owner”, the applicant shall have ownership or disposal right to the income or the assets and/or rights generating such income. In practice, Chinese tax authorities will examine more the substance over the form to ascertain whether the applicant conducts substantive operation activities in Hong Kong. On the other hand, it has been made clear that agents and conduit companies will not be deemed as “beneficial owner”.

A conduit company is defined to be a company set up for purpose of evading or reducing taxes or transferring or cumulating profits but not engaged in any substantive manufacturing, distribution and management activities.

Separate Note

We note that Singapore has been given quite a few favorable tax treatment as stipulated in the bilateral income tax treaties between China and Singapore, though not so good as those availed to Hong Kong.

For example, in the case of dividends received by Singaporean investors, the income tax rate levied on such dividends can be as low as 5% provided that the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends. Compared with the tax treatment for HK, individual investors from Singapore will not benefit from this favorable treatment.

Similarly, income tax levied on interest received by Singaporean residents can be as lower as 7% of gross amount of interest, provided that the receipient is a bank or financial institution. Here again, the favorable treatment is accorded to financial institutions only while it is applicable to all receipients in Hong Kong.

If you have any comment on this subject, please contact the author of this blawg.

Date Created
March 2013
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