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# Hong Kong Tax Alert

2 January 2019
2019 Issue No. 1

## Issues to be considered when applying for a Hong Kong certificate of residence (CoR) in order to claim tax benefits under a tax treaty

*In its 2018 annual meeting with the Hong Kong Institute of Certified Public Accountants (HKICPA), the Inland Revenue Department (IRD) explained:*

*(i) the factors that the IRD, in processing an application for a certificate of residence, would consider in determining whether a taxpayer is the beneficial owner of an income item and hence their entitlement to tax treaty benefit claims;*

*(ii) what a taxpayer needs to state in their application if (a) they seek a CoR demonstrating that they are a permanent resident individual vis-à-vis a temporary resident individual of Hong Kong; and (b) they seek a CoR for Year 3 when a CoR for Year 1 has already been issued; and*

*(iii) the procedures that a taxpayer should follow if they seek a higher second-level review within the IRD of their CoR application which has initially been rejected by an IRD case officer.*

*This alert discusses the issues involved. Clients who have questions on the views expressed by the IRD in the meeting, or would like to discuss in greater detail how such views might impact their business operations, should seek professional tax advice.*

## Beneficial ownership of an income

The IRD explained in the meeting that a CoR served to prove the Hong Kong resident status of a taxpayer for the purposes of claiming tax benefits under tax treaties. As a responsible treaty partner, in deciding whether a CoR can be issued, the IRD would consider, among other things, whether an applicant was the beneficial owner of the income concerned and hence whether the applicant was entitled to the relevant treaty benefits.

Pursuant to the Commentary to the Model Tax Convention of the Organization for Economic and Co-operation Development (OECD), the IRD noted that the term "beneficial owner" was not to be interpreted in a narrow technical sense. Rather the term should be understood in the light of the object and purpose of comprehensive agreements for the avoidance of double taxation (CDTAs), including avoiding double taxation and the prevention of fiscal evasion and avoidance. A person simply acting as a "conduit" for another person, who in fact received the benefit of the income concerned, was not the beneficial owner. Similarly, a person whose right to use and enjoy the income concerned was constrained by a contractual or legal obligation to pass on the payment received to another person was not the beneficial owner.

Following the OECD's interpretation of the term "beneficial owner", the IRD considered that whether a company was the beneficial owner of an income item was a question of fact, depending on the circumstances of each case. There was no exhaustive list of the factors to be considered. As a matter of practice, the factors that the IRD might take into consideration include:

- the legal owner of the relevant asset;
- the economic substance of the taxpayer;
- whether the taxpayer had any obligation to pass on the income received to another person;
- the extent of the taxpayer's power to decide on the use of the relevant asset; and
- the income derived therefrom, i.e. whether the taxpayer assumed the risk and control of the income, etc.

In addition, the IRD advised that application forms for a CoR in Hong Kong would be changed as a result of the recent clarification by the State Administration of Taxation (SAT) of mainland China in its Circular 2018 No. 9 as to how the term "beneficial owner" was to be interpreted.

## Permanent residence vis-à-vis temporary residence of an individual

Under the Mainland-Hong Kong CDTA, an individual who stays in Hong Kong for more than 180 days in a year of assessment or more than 300 days in two consecutive years of assessment, one of which being the year of assessment in question, would qualify as a temporary resident of Hong Kong for the year of assessment in question.

An individual whose physical presence in Hong Kong does not meet the above threshold may nonetheless qualify as a permanent resident of Hong Kong under the Mainland-Hong Kong CDTA if they can prove that they ordinarily reside in Hong Kong during the year of assessment in question (i.e., by reference to other strong personal ties with Hong Kong).

The concern raised by the HKICPA in the meeting was that it appeared that in practice once an applicant satisfied the temporary resident route, the IRD would simply issue a CoR showing only their temporary residence in Hong Kong. This would be the case even though the applicant may also qualify as a permanent resident of Hong Kong.

However, not being able to demonstrate that they are also a permanent resident of Hong Kong, an applicant may not be able to obtain the tax benefits under the Mainland-Hong Kong CDTA under Guoshuihan [2007] No. 403 (Circular 403) issued by the SAT.

According to Clause 3(3) of Circular 403, if an individual is a Hong Kong temporary resident and a permanent resident of another jurisdiction, the tax treaty between the Mainland and the other jurisdiction (rather than the Mainland-Hong Kong CDTA) should apply. If there is no tax treaty between the Mainland and the other jurisdiction, the Mainland domestic tax law should apply. As such, the Mainland tax authority may reject the tax benefit claims under the Mainland-Hong Kong CDTA if the Hong Kong CoR is issued under the temporary resident route.

In reply, the IRD explained that in practice, if an individual clearly indicated in their application that they would apply for a CoR under the permanent resident route, the relevant IRD officer would consider such an application. In processing an application under the permanent route, the IRD would, apart from considering the period of the physical presence of the individual in Hong Kong, also consider all the other facts and circumstances of the case during the relevant year of assessment (e.g., whether the individual habitually and normally resided in Hong Kong, where their family members habitually lived, whether they had any social and economic ties with Hong Kong etc.).

The IRD further advised that if an individual was issued with a CoR under the temporary resident route, and they considered that they were an ordinary or a permanent resident of Hong Kong, they could contact the IRD officer to see whether further information and documents could be submitted to support the issuance of a CoR under the permanent resident route.

## CoR for Year 3 when a CoR for Year 1 has been issued

Under the current administrative arrangement agreed between the IRD and the SAT, a CoR issued by the IRD will generally serve as a proof of the Hong Kong residence of a taxpayer for the purposes of the Mainland-Hong Kong CDTA for the year covered by the CoR and two subsequent years.

The question raised by the HKICPA was: regardless of the above arrangement, whether the IRD would consider issuing a CoR to the taxpayer under the circumstances outlined in an example provided by the HKICPA.

In the HKICPA's example, Company A had been issued with a CoR for the calendar year 2014. In late 2016, Company A contemplated that it would receive a dividend from its subsidiary in the Mainland in January 2017 and Company A was requested by the Mainland tax authority to submit a CoR issued in 2016 or 2017. To complete the remittance of the dividend in January 2017, Company A applied to the IRD in late 2016 requesting a CoR for the calendar year 2016.

In response, the IRD noted that the CoR issued to Company A for the calendar year 2014 should suffice for the purpose and it would not be necessary for Company A to apply for a CoR for the calendar year 2016.

As such, under normal circumstances, the IRD would not entertain an applicant's request for a CoR for Year 3 if a CoR for Year 1 had been issued. However, if a Hong Kong resident taxpayer encountered real difficulties in claiming treaty benefits and was specifically requested to submit a CoR for Year 3 by the Mainland tax authority, they could elaborate in their CoR application the reasons and circumstances for requiring a CoR for Year 3 despite that it had been issued a CoR for Year 1. The IRD would consider the facts and circumstances of each individual case to see if the application should be entertained.

Referring to the example, the IRD noted that under Gonggao [2017] No. 37 issued by the SAT which took effect from 1 December 2017, the timing of withholding tax obligation on dividends derived by a non-resident company was changed from the date of resolution of payment to the date of actual payment.

Accordingly, where a Hong Kong resident company expected in December of Year 3 to receive dividends from its Mainland subsidiary in January of Year 4, the relevant calendar year of claim was Year 4.

In such circumstances, the Hong Kong resident company seeking tax benefits on dividends under the Mainland-Hong Kong CDTA might wish to obtain a CoR for Year 3 to prove their resident status covering Year 4. If that was the situation, the IRD indicated that taxpayers should also elaborate in their CoR application the reasons and circumstances for requiring a CoR for Year 3.

The IRD nonetheless indicated that, regardless of whether taxpayers can produce written evidence from the Mainland tax authority in support of their CoR applications, the IRD would adopt a more flexible approach in dealing with such cases without requiring excessive elaboration from taxpayers.

## Scope for a higher second-level review within the IRD when a CoR application is initially rejected

A CoR issued by the IRD demonstrating that a taxpayer is a tax resident of Hong Kong is normally required when a taxpayer claims tax relief in the other jurisdiction under the terms of a relevant CDTA.

The Inland Revenue Ordinance does not however contain any provisions concerning the issuance of a CoR by the IRD. The current administrative practice of the IRD is that if the IRD considers that, based on the facts and evidence presented, an applicant is not a Hong Kong resident or is abusing the terms of a CDTA, the IRD will refuse to issue a CoR to the applicant.

However, the interpretation of the facts and evidence of a case may have some element of subjectivity. In this regard, the question asked by the HKICPA was: can an applicant seek a higher second-level review within the IRD when their CoR application was initially rejected by an IRD case officer?

The IRD responded that the IRD had all along been committed to providing Hong Kong residents with assistance in claiming the tax benefits to which they were entitled under a CDTA. When processing a CoR application, the IRD officers would thoroughly examine the relevant facts of the application and exercise professional judgment accordingly.

The IRD noted that:

- If a CoR application had to be declined, the IRD would give the reasons for its decision.
- If new and material information and documents were subsequently available (e.g., information relating to the significant controllers of a company formed and registered under the Companies Ordinance which was previously not available), the applicant could furnish such information and documents to the Assessor for reconsidering the application.
- Where the previous application was based on incomplete or incorrect information, the applicant might apply afresh with complete and correct information.

The IRD took the view that the above arrangement had been working well and a separate formal review mechanism within the IRD might not be warranted. Nonetheless, in response to the concerns raised by the HKICPA, the IRD agreed that an applicant could take the following steps to pursue an application for a CoR that had initially been rejected:

- The applicant should first contact the case officer to see whether further information and documents could be submitted to support the issue of a CoR.
- If the case officer maintained the decision of not accepting the CoR application, the applicant could request the case to be referred to the Chief Assessor of Tax Treaty Section for further review.

Many of the issues discussed above are complicated. Clients who have questions on the views expressed by the IRD in the meeting, or would like to discuss in greater detail how such views might impact on their business operations, should seek professional tax advice.

Hong Kong office
**Agnes Chan**, Managing Partner, Hong Kong & Macau
22/F, CITIC Tower, 1 Tim Mei Avenue, Central, Hong Kong
Tel: +852 2846 9888 / Fax: +852 2868 4432

EY Asia-Pacific Business Tax Services Leader

**Tracy Ho**
+852 2846 9065
tracy.ho@hk.ey.com

EY Asia-Pacific International Tax Services Leader

**Alice Chan-Loeb**
+852 2629 3882
alice.chan@hk.ey.com

EY Greater China Business Tax Services Leader

**Chee Weng Lee**
+852 2629 3803
chee-weng.lee@hk.ey.com

Hong Kong Business Tax Services Partners, Ernst & Young Tax Services Limited

**Agnes Chan**
+852 2846 9921
agnes.chan@hk.ey.com

**Wilson Cheng**
+852 2846 9066
wilson.cheng@hk.ey.com

**May Leung**
+852 2629 3089
may.leung@hk.ey.com

**Grace Tang**
+852 2846 9889
grace.tang@hk.ey.com

**Karina Wong**
+852 2849 9175
karina.wong@hk.ey.com

**Jo An Yee**
+852 2846 9710
jo-an.yee@hk.ey.com

International Tax Services partners, Ernst & Young Tax Services Limited

**Cherry Lam**
+852 2849 9563
cherry-lw.lam@hk.ey.com

**Jeroen van Mourik**
+852 2846 9788
jeroen.van.mourik@hk.ey.com

**Aaron Topol**
+852 2675-2980
Email: aaron.topol@hk.ey.com

Transfer Pricing Services partners, Ernst & Young Tax Services Limited

**Martin Richter**
+852 2629 3938
martin.richter@hk.ey.com

**Kenny Wei**
+852 2629 3941
kenny.wei@hk.ey.com

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