

Highlights of the tax treaty between India and Hong Kong

Background

Recently, India and Hong Kong Special Administrative Region of People's Republic of China (Hong Kong) signed a tax treaty. The tax treaty will stimulate the flow of investment, technology and personnel from India to Hong Kong and vice versa, prevent double taxation and provide for the Exchange of Information (EOI) between the two states. It will improve transparency in tax matters and will help to curb tax evasion and tax avoidance. Highlights of the tax treaty are as follows:

Taxes covered

The tax treaty applicable to taxes on income imposed on behalf of a state, or of its political subdivisions or local authorities. Taxes on income means all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of movable or immovable property and taxes on the total amounts of wages or salaries paid by enterprises. The tax treaty is applicable to existing taxes. In case of India, such tax is an income tax in India, including surcharge thereon. In case of Hong Kong, such taxes are profits tax, salaries tax, and property tax. The tax treaty shall also apply to any identical or substantially similar taxes that may be imposed in future. It does not include any penalty or interest or fine imposed under the domestic laws.

Residence

The term 'resident of a contracting party' means, in the case of Hong Kong, any individual who ordinarily resides in Hong Kong. It also includes if an individual who stays in Hong Kong for more than 180 days during the relevant assessment year or for more than 300 days in two consecutive assessment years¹. However, for companies, the criteria is based on its place of incorporation. Any other person constituted under the laws of Hong Kong will

be treated as resident. For companies/other persons incorporated outside the Hong Kong, the place where it is normally managed or controlled².

In India, the term 'resident' means any person who is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. This term, however, does not include any person who is liable to tax in India in respect of only income from sources in India.

The term person is defined in the tax treaty to include an individual, a company, a partnership, a trust and any other body of a person which is treated as a taxable entity under domestic tax law.

Tie-breaker test in case of dual residency

Where an individual is a resident of both states, then his status shall be determined based on following factors:

- Permanent home available to him
- Centre of vital interests
- Habitual abode
- The right of abode/nationality
- Mutual Agreement Procedure (MAP) process, etc.

Residency in the case of a person other than an individual shall be determined by MAP, having regard to its Place of Effective Management (POEM), the place where it is incorporated or otherwise constituted and any other relevant factors.

² The protocol provides that a company incorporated or any other person constituted outside Hong Kong is normally managed or controlled in the Hong Kong if its executive officers and senior management employees make day-to-day key decisions in the Hong Kong for the strategic, financial and operational policies for the company or the person, and the staff of the company or the person conduct in the Hong Kong, the day-to-day activities necessary for making those decisions.

¹ One of which is the relevant assessment year

In the absence of a MAP, such individual/person shall not be entitled to any relief or exemption from tax provided by the tax treaty except to the extent and in such manner as may be agreed upon by the competent authorities of the contracting states.

Permanent Establishment

Fixed PE

- The term Permanent Establishment (PE) includes especially a place of management, a branch, an office, factory, workshop, sales outlet, a warehouse in relation to a person providing storage facilities for others, a farm, plantation or other place where agricultural, forestry, plantation or related activities are carried on, and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Construction, installation, assembly PE etc.

- A building site, a construction, assembly or installation project or supervisory activities in connection therewith constitutes PE if such site, project or activities last more than six months.

Service PE

- Furnishing of services, including consultancy services, through personnel or employees, shall constitute a PE, if activities of that nature continue (for the same or a connected project) within a contracting state for a period or periods aggregating more than 183 days within any twelve-month period.

Agency PE

- The tax treaty contains Agency PE clause which provides that dependent agent, acting in the state on behalf of an enterprise of other state, shall be treated as having a PE in the first-mentioned state in respect of any activities which that person undertakes for the enterprise if such a person :
 - has and habitually exercises in the source state an authority to conclude contracts in the name of enterprise, unless the activities of such person are limited to those mentioned in Article 5(4) which, if exercised through a fixed place of business, would not make this fixed place of business a PE under the provisions of that paragraph, or
 - has no such authority, but habitually maintains in the source state a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise;
 - has no such authority, but habitually secures orders in the source state, wholly or almost wholly for the enterprise or its associated enterprise.

Exemption from PE

The term PE shall be deemed not to include use of facilities solely for the purpose of storage and display of goods or merchandise, maintenance of stock of goods solely for storage or display, maintenance of stock of goods solely for processing, maintenance of fixed base solely for purchasing goods or merchandise or for collecting information, maintenance of fixed base solely for any other activity of a preparatory or auxiliary character.

Further, it also shall not include maintenance of fixed base solely for the combination of activities mentioned above provided that the overall activity of the fixed place of business resulting from the combination is of a preparatory or auxiliary character.

Business profits and its attribution

Article 7 of the tax treaty also provides for source taxation of business profits to the extent attributable to PE in the source country. While determining the profits of a PE, expenditure which are incurred for the purpose of PE, including executive and general administrative expenditure shall be allowed as deduction.

The provision allows for the application of an apportionment method or any other prescribed method as may be prescribed in the source country and to the extent, it is in accordance with the principle of Article 7.

No profits shall be attributed to a PE by reason of the mere purchase by that PE of goods or merchandise for the enterprise.

Shipping and air transport

Profits of an enterprise from the operation of ships or aircraft in international traffic shall be taxable only in the resident country. Such profits from the operation of ships or aircrafts in international traffic may also be taxed in the source state with 50 per cent reduction in taxes imposed.

Associated Enterprise

The tax treaty provides for a corresponding adjustment in the profits of AE in the other state:

- where an adjustment has been made by a state to profits of a resident, based on arm's length condition and taxes are levied on such profits adjusted and
- such profits are also taxed in the hands of AE in the other state

Dividend and interest

Dividend/interest may be taxed in the resident state. However, such dividend/interest may also be taxed in the source state, but if the beneficial owner is a resident of other state, tax rate at 5 per cent on a gross basis is applicable in the case of dividend whereas it is at 10 per cent on a gross basis in the case of interest.

Further, interest is exempt from tax if it is derived and beneficially owned by the government, a political subdivision or a local authority of the other state, Reserve Bank of India, Export-import bank of India, or any other institution as may be agreed by the contracting states.

Where such incomes are effectively connected to a PE/fixed base in the source country, taxation will be governed by the provisions of Article 7 or Article 15.

The benefits of dividend and interest provisions shall not be available if the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares/other rights or debt-claim in respect of which the dividends/interests are paid is to take advantage of these articles by means of that creation or assignment.

Royalties and Fees for Technical Services

Royalty/Fees for Technical Services (FTS) may be taxed in the resident state. However, such royalty/FTS may also be taxed in the source state, but if the beneficial owner is a resident of other state, tax rate at 10 per cent on a gross basis is applicable.

The term 'royalty' has been defined to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for television or radio broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

The term 'Fees for Technical Services' has been defined to mean consideration for managerial or technical or consultancy services, including the provision of services of technical or other personnel but does not include payments for independent personal services and for dependent personal services.

Where such incomes are effectively connected to a PE/fixed base in the source country, taxation will be governed by the provisions of Article 7/Article 15 on a net basis.

The benefits of Royalty and FTS provisions shall not be available if the main purpose or one of the main purposes of any person concerned with the creation or assignment of the rights in respect of which the royalties are paid or performance of services in respect of which the technical fees are paid is to take advantage of these articles.

Capital gains

- Gains derived by a resident of a state from the alienation of immovable property referred in Article 6 and situated in the other state may be taxed in that other state.
- Gains from the alienation of movable property forming part of business property of a PE or gains from the alienation of movable property pertaining to a fixed base for the purpose of performing independent personal services, including gains from alienation of such PE (alone or with the whole enterprise) or of such fixed base may be taxed in the state where the immovable property is situated.
- Gains from the alienation of ships or aircraft operated in international traffic, or movable property pertaining to the operation of such ships or aircraft shall be taxable only in the state in which the alienator is a resident.
- Gains from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from the immovable property will be taxed in the state where the immovable property is situated.
- Gains from the alienation of shares other than those referred above will be taxable in the state of which the company is a resident.
- Gains from the alienation of any property, other than referred above, may be taxed in each state in accordance with the provisions of its domestic law.
- The benefits of the capital gains tax provisions shall not be available if the main purpose or one of the main purposes of any person concerned with the alienation of property in respect of which the capital gains are derived is to take advantage of this article by means of that alienation.

Independent Personal Services

Income derived by an individual from performance of professional services or other independent activities of a similar character shall be taxable only in the resident state unless such individual has fixed base regularly available to him in the source state for the purpose of performing his activities or his/her stay in the source state is for a period or periods amounting to or exceeding 183 days in any 12 months period commencing or ending in the year of assessment, i.e., fiscal year in the case of India.

Dependent Personal Services

Income in respect of salary, wages, and other similar remuneration may be taxed in source state where employment is exercised unless his/her presence in the source state does not exceed 183 days in any 12 months period

commencing or ending in the fiscal year concerned and the remuneration is paid by, or on behalf of, an employer who is not a resident of the source country, and the remuneration is not borne by a PE or a fixed base which the employer has in the other country.

Other income

Items of income of a resident of a state, wherever arising, not dealt with any of the provisions of the tax treaty shall be taxable only in that state.

Primary rights to tax 'other income' is accorded to the resident state. Such income may also be taxed in the source state where such income is arising.

Method to eliminate double taxation

In order to eliminate the double taxation on a person, both the states allow Foreign Tax Credit (FTC) for the taxes paid in either of the states. The relief is provided by way of credit method subject to maximum deduction limit.

Non discrimination

The tax treaty provides non-discrimination provisions which protect nationals and businesses of one state from non-discrimination in the other state with regards to taxation, or any requirement connected therewith which is other than or more burdensome than the taxation and connected requirements of the second mentioned state. The taxation on a PE which an enterprise of a state has in the other state shall not be less favourably levied in that other state than the taxation levied on enterprises of that other state carrying on the same activities.

Mutual Agreement Procedure

- The tax treaty provides for MAP, where a person may present its case to the competent authority of its resident state if it considers that the actions of one or both of the state result or will result in taxation not in accordance with the provisions of the tax treaty. The case must be presented within three years from the first notification of the action resulting in taxation.
- The competent authority shall endeavour to resolve the case by mutual agreement with the competent authority of the other state. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the states.

Exchange of information

- The competent authorities of contracting State shall exchange such information as is necessary for carrying out the provisions of the tax treaty or of the domestic laws of the states concerning taxes of every kind and description³.

- Any information received by a contracting state shall be treated as secret in the same manner as information obtained under the domestic law of that state and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes. The information shall be used only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.
- The other State cannot decline to supply information, solely because there is no tax interest in such information to that party.
- A State cannot decline to supply information solely because the information is held by a bank, other financial institution, etc. or because it relates to ownership interests in a person.

Limitation Benefit (anti-avoidance rule)

- The provisions of the tax treaty shall in no case prevent a state from the application of the provisions of its domestic law and measures concerning tax avoidance or evasion, whether or not described as such.
- A state is not required to grant benefits under the tax treaty if the main purpose or one of the main purposes of any persons concerned is for the non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the tax treaty for the indirect benefit of residents of third jurisdictions).
- Cases of legal entities not having bona fide business activities shall also be covered by the provisions of this Article.

Entry into force

Each of the countries shall notify the other in writing of the completion of the procedures required by its law for the entry into force of this tax treaty. The tax treaty shall enter into force on the date of the later of the notifications by respective states. The provisions of tax treaty shall have an effect, in India, in respect of income derived in any fiscal year beginning on or after 1 April following the date on which the tax treaty enters into force.

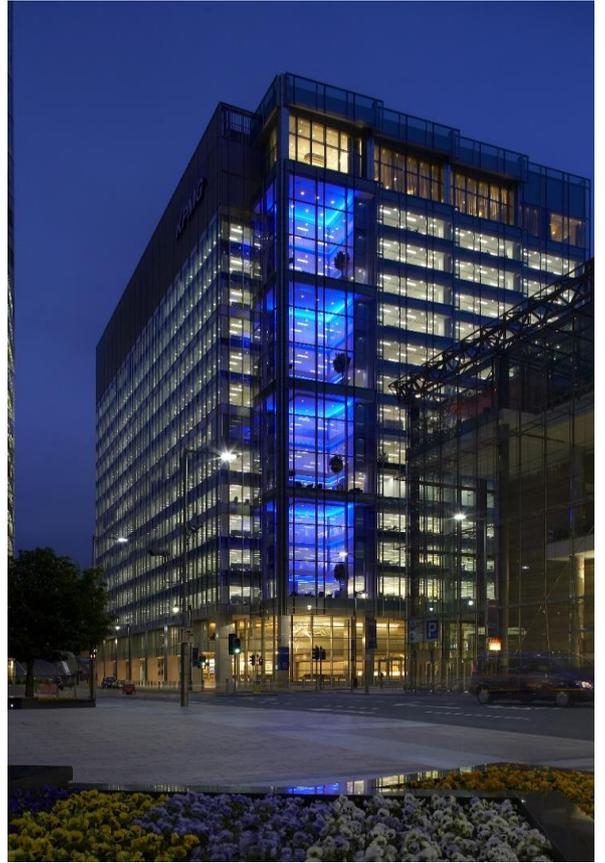
³ The protocol clarifies that in addition to the taxes covered by the tax treaty, the provisions of Exchange of Information Article also apply to (i) the wealth tax (ii) the excise and customs duties (iii) the goods and services tax (GST) and (iv) the sales and value added taxes.

Our comments

The India-Hong Kong tax treaty is a welcome step which will help improve transparency in tax matters and curb tax evasion and avoidance. The tax treaty has provided beneficial withholding rates in case of dividend, interest, royalty, and FTS. However, such beneficial provisions are subject to anti-avoidance provisions. In line with the recent trend of the introduction of Limitation of Benefit (LOB) clause under the Indian tax treaties, such a clause has been introduced in this tax treaty. The LOB clause under the tax treaty also provides for applicability of domestic anti-avoidance provisions.

The tax treaty provides FTC which will help taxpayers to reduce their tax burden. Further, EOI article will help both the states to comply with international standards with respect to transparency and reducing tax evasion.

The tax treaty includes some of the provisions of the Multilateral Instrument (MLI). India and Hong Kong are both signatories to MLI. There is liberal use of Principle Purpose Test (PPT) in respect of the overall treaty and passive income streams in particular.



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