

New China-Hong Kong Tax Treaty – Hong Kong as a Base for Investment in China

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From a Public International Law perspective, the political arrangement between China and Hong Kong is proving to be interesting. Pursuant to the Sino-British Agreement of 1984, on July 1, 1997 sovereignty over Hong Kong was transferred from the United Kingdom to the People's Republic of China. One of the principles of Public International Law is that a country cannot enter into an agreement with itself; yet China and Hong Kong entered into the above-mentioned DTA on August 21. Because China and Hong Kong are not two independent states, one could argue that the August DTA is null and void; but this is not the case.

China's Basic Law refers to Hong Kong as the "Hong Kong Special Administrative Region," or HKSAR, and the two regions are treated as — this is where it gets interesting — "one country, two systems." This may sound like a typical internal administrative arrangement with no consequences outside a country's borders, but it is not. One area where it is proving not to be a "typical administrative arrangement" is in that of international taxes. In this area, China and Hong Kong act like two independent states. For example, Hong Kong is not allowed to claim treaty benefits pursuant to China's existing Tax Agreements. Members of the international community likewise do not consider Hong Kong and China to be a single country. For example, on June 26, 1997, the United States' IRS announced that, for US tax purposes, it treats China and Hong Kong as two separate countries.

How does this all affect a US company doing business in that part of the world? In the first place, there is no DTA in effect between the US and Hong Kong, only between the US and China. As stated before, the benefits of this treaty are not available to a US person doing business with a Hong Kong-based entity. Secondly, the withholding rates provided in the new China-Hong Kong DTA are generally lower than those set forth in the US-China DTA (See Table 1 for a comparison). Thus, from a tax planning perspective, a US

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business may benefit from using Hong Kong as a base for investing in China, once the new China-Hong Kong treaty is in effect.

Table 1

	US-China DTA	China-HK DTA
Dividends:	10%	10%/5%(1)
Interest:	10%	7%
Royalties:	10%/7%(2)	7%/0%(3)

- If Hong Kong Company owns at least 25% of Mainland Company's capital, the rate is 5%.
- If Royalties are paid for rental of industrial, commercial or scientific equipment, the Royalty rate of 10% shall be applied on 70% of the gross amount of such Royalties.
- On interest payable from China, the rate is 7%. The 0% rate applies to interest received by the Hong Kong Government or other recognized institutions.

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