DEACONS
的近律師行

Corporate Commercial Client Alert

Tax

8 August 2022

International tax alert: certificates of resident status (CoR) in Hong Kong

Stefano Mariani

It is well-understood that the Hong Kong Inland Revenue Department ("**IRD**") will not issue a CoR to an applicant company that is treaty resident in Hong Kong for the purposes of seeking the benefit of a double taxation agreement ("**DTA**") to which Hong Kong is a party unless the applicant can show that it has sufficient economic substance in Hong Kong. By economic substance, the IRD means physical operations and management or control in Hong Kong including, but not limited to, office premises, employees, board meetings, and business assets in Hong Kong. This economic substance requirement is, however, devoid of any statutory basis: it is a purely administrative measure. Consequently, there was and remains an apparent inconsistency between the criteria for a company to be treaty resident in Hong Kong for the purposes of a given DTA – in general, it is sufficient that a company be incorporated in Hong Kong or normally managed or controlled in Hong Kong for it to be treaty resident in Hong Kong – and the IRD's practice in issuing a CoR. The IRD in effect imposes additional, non-statutory conditions to the grant of a CoR. That inconsistency is undesirable because it is unfounded in legislation, thereby vesting the IRD with unfettered discretionary powers, and is not conducive to legal certainty when it comes to international tax planning.

In our recent experience, however, the IRD is aware of the technical precariousness of its position when it comes to its refusal to issue a CoR to an applicant company that is as a matter of law treaty resident in Hong Kong, and is reluctant to resist an application on the part of the applicant company to institute judicial review proceedings against the Commissioner of Inland Revenue (the "**Commissioner**") for declining to issue a CoR. In appropriate cases, applicants may evaluate this as a solution to a refusal to grant a CoR.

Background

We were instructed by a company (the "**Company**") to bring judicial review proceedings against the Commissioner for declining to issue it with a CoR for the calendar year 2021 notwithstanding that it was, as a matter of law, treaty resident in Hong Kong in that year by virtue of being incorporated in Hong Kong. The Commissioner had declined to issue the Company with a CoR because he claimed that it had insufficient economic substance in Hong Kong: it did not have any material commercial operations in this jurisdiction.

Since 20 October 2015, the Company carried on the business of investing in private companies as part of a venture capital undertaking. In 2021, it sold certain shares in an investee company and derived a substantial gain. If the Company could show that it was resident in Hong Kong for the purposes of the DTA between Hong Kong and the Mainland, then its gains would be sheltered from tax in the Mainland because taxing rights would have been allocated exclusively to Hong Kong under Art.13(6), and exempt from tax in Hong Kong, as under s.14(1) of the Inland Revenue Ordinance, gains from the disposal of capital assets are expressly exempt from profits tax. In short, the Company would have avoided tax entirely on the gain.

Article 4(1)(2)(iii) of the Hong Kong – Mainland DTA provides that for the purposes of the DTA, a company is treated as resident in Hong Kong if:

> "[it is] incorporated in the Hong Kong Special Administrative Region, or if incorporated outside the Hong Kong Special Administrative Region, being normally managed or controlled in the Hong Kong Special Administrative Region".

A company is therefore treaty resident in Hong Kong on the terms of that DTA if either: (1) it is incorporated in Hong Kong; or (2) normally managed or controlled in Hong Kong. That is a strict definitional provision, with no apparent

qualification. It followed that the Company was, as a matter of law, treaty resident in Hong Kong in 2021 by virtue of being incorporated in Hong Kong.

We therefore applied on behalf of the Company to the High Court for a declaration that refusal to grant a CoR was unlawful and/or unreasonable and/or contrary to the legitimate expectations of the Company and an order *mandamus* to compel the Commissioner ot issue the Company a CoR. Such applications must under Order 53, rule 4 of the Rules of the High Court be made within three months of the date of the decision of the public body that the applicant wishes to review. As the Company only discovered it had an administrative law remedy in April 2022 after instructing us, its application was over two months late.

Upon our filing of the Company's application for leave to bring judicial review, the Court directed that there be a single rolled up hearing to decide: (1) whether the Company should be granted a time extension such that the Court could hear its application notwithstanding the delay; (2) whether the Company should be granted leave to bring judicial review against the decision of the Commissioner not to issue a CoR; and (3) if so, whether the Court should make an order *mandamus* compelling the Commissioner to issue a CoR.

The resolution

Some four months before the hearing date fixed by the Court, the Commissioner offered to issue the CoR to the Company if it agreed to withdraw its judicial review application, with no order as to costs (i.e., each side bore its own legal costs). The Company accepted that offer and was duly issued the CoR for 2021.

It is important to note that each case will necessarily turn on its own facts; however, on the basis of our experience in the above case we would make the following observations:

1. The IRD is conscious that its policy to deny requests to issue a CoR purely on the grounds of limited economic substance is not currently on sound statutory footing.

2. The IRD may therefore be amenable to revisit its decision not to issue a CoR in appropriate circumstances and, in particular, where the applicant can show that it is unambiguously treaty resident in Hong Kong on the terms of the relevant DTA.

3. If a sufficient amount of tax were at stake, an unsuccessful applicant for a CoR may consider the prospect of instituting judicial review proceedings.

How we can help

International tax planning is often complex, and the specific approach to be taken in each case will depend on the precise terms of the relevant DTA(s). We have extensive experience advising clients in both non-contentious and contentious international taxation matters, including, where necessary advising on matters of administrative law in Hong Kong and public international law in context of the interpretation and application of DTAs.

Want to know more?

Cynthia Chung
Partner
cynthia.chung@deacons.com
+852 2825 9297

Machiuanna Chu
Partner
machiuanna.chu@deacons.com
+852 2825 9630

Stefano Mariani
Partner
stefano.mariani@deacons.com
+852 2825 9314