



## **Reinventing Hong Kong – 2**

**Source: JFU**  
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In our Note issued on 14th November 2011 we suggest Hong Kong, with its ever expanding network of double tax treaties, can reinvent itself as a centre for managing and conducting global business.

### **Sourcing and Trading Portal**

This Note advocates that Hong Kong now has a special advantage in playing the role as the sourcing and trading portal between the regions of production and the regions of consumption. It is because Hong Kong has entered into a comprehensive network of tax treaties and arrangements with countries of supply such as Mainland China, Vietnam, Thailand, Indonesia and India (under negotiation) and countries of consumption such as the UK, France, Spain and Italy (under negotiation).

Typically enterprises entering into new jurisdictions would do so with a light touch, for example establishing a representative office and then, once more certain of the opportunities offered by the jurisdiction, consolidating their position by creating an entity, either in conjunction with local partners or as wholly foreign owned.

Establishing an entity in a jurisdiction presents formidable challenges such as capital commitments, hiring a work force, unfamiliar practices, and potentially heavy local tax burdens. Two reasons are often cited for the establishment of an entity and as a consequence dealing with such challenges: first, the need to maintain control of quality, risk and finance, and the other, the potentially unmanageable tax exposure that could be created through certain activities or the presence of staff in the other jurisdiction. In "tax speak" this tax exposure is caused by creating a permanent establishment in the other jurisdiction. A permanent establishment is not necessarily a physical place of business; often, it is a notional one that may come into existence inadvertently due to technical definitions without the awareness of the business operator. The resultant tax risk can later become so disruptive that it may threaten the business operation itself.

### **A Business Model for the Sourcing and Trading Portal**

The first reason cited could be taken as an indication of a lack of trust in local partners. However, we have seen anecdotal evidence in Hong Kong and Mainland China of the mutual benefits obtained through contractual arrangements such as contract processing arrangements that have been a common practice for over 20 years. The fact that these arrangements are being phased out is not an

indication of a lack of trust or control in such business associations, but rather due to enforcement requirements intended to remove undesirable practices. The success of the contract processing arrangements can be taken as an indicator to global players that they can conduct their business through appropriate contractual agreements, such as Master Supply Agreements provided that the arrangement is beneficial to both parties and good business practice is observed.

The second issue can now be better addressed and managed by establishing a resident company in Hong Kong that functions as a sourcing and trading portal, capitalizing on Hong Kong's expanding network of tax treaties, along with a series of contractual arrangements with the preferred local partners in the countries of supply and countries of consumption.

Most recently concluded double tax treaties follow the OECD Model Tax Convention, whereby Article 5 of the Treaty defines which activities constitute a permanent establishment in a jurisdiction and more specifically which do not. Insofar as sourcing and trading is concerned, the most relevant exclusions in most treaties for Hong Kong are for buying offices and activities performed by independent agents.

Hong Kong resident companies can send sourcing and quality personnel to visit the countries of supply to locate new suppliers, establish buying offices there and even appoint independent agents to conclude contracts on their behalf without exposing themselves to taxation in relevant jurisdictions. This also avoids the potentially huge capital cost of setting up a company, associated infrastructure and running costs.

### **Employment, Motivation and Business Effectiveness**

An effective business model cannot be built merely on technical concepts. Effectiveness counts on the competence of people who runs the business. While Hong Kong has a relatively low unemployment rate, many are not employed in jobs that allow them to exert their potential to the full extent. As mentioned in our earlier Note, there is an educated and highly skilled work force in Hong Kong who are being potentially marginalized by the inability to get employment that affords them a chance of giving the best of what they can do. Experienced workers in logistics, engineering, purchasing and even finance are part of this underemployed workforce. Global businesses setting up their hub in Hong Kong would have access to this workforce, bringing mutual benefits to both sides. The global business would have a work force that understands local and international cultures, are multi lingual and are adept in learning new skills or deploying existing skills. Amply rewarded, these employees will be highly motivated.

### **Tax Efficiency**

The business model as discussed above for global business setting up a fully fledged entity in Hong Kong to do sourcing and trade can avoid double taxation risks due to inadvertently created overseas presence with the help of Hong Kong's network of international tax treaties. Furthermore, it may potentially benefit from either zero or low (16.5%, current standard rate) taxation on profits due to Hong Kong's source based domestic tax legislation.

We believe this would be a reinvention of Hong Kong that benefits all stake holders.