



Reinventing Hong Kong – 3

Source: JFU
31 January 2012

It has been our suggestion that with a simple source based tax jurisdiction and an expanding tax treaty network, Hong Kong can reinvent itself as a center for conducting global business. In our Notes issued on 24 November 2011, we discussed a business model for running a Sourcing and Trade portal. We are going to examine another one in this Notes.

Holding and Treasury Centre

This Notes focuses on how Hong Kong can capitalize on this expanding double tax treaty network and its unique and simple, source based tax system to position itself as the home for Holding and Treasury Centers for regional and global groups. At the last count, Hong Kong has concluded 23 Comprehensive Double Tax Treaties with various countries and jurisdictions; a number of other treaties are currently under negotiation.

Hong Kong has a reputation as being one of the leading financial centers of the world due to its transparent regulatory system, sound legal framework and absence of exchange controls. Global business setting up their holding and treasury centers in Hong Kong can also benefit from this well recognized institutional infrastructure. If they are only engaging in intra group funding as defined, there is no need for them to obtain banking or money lender licenses and hence there is no onerous reporting or capital obligations placed upon them leaving them ideally positioned to provide tax and business efficiency to the group.

A Business Model for the Holding and Treasury Center

Previously, Hong Kong might not have been an attractive location for establishing holding companies as the lack of double tax treaties might have resulted in a large withholding tax burden on the payment of dividends from investee companies. Such tax burden was neither creditable nor deductible as an expense in Hong Kong.

Now, however, Hong Kong has a relatively comprehensive treaty network so it can offer itself as an attractive jurisdiction for Holding Company given that the withholding tax burden may be reduced. For example, under the Arrangement between Hong Kong and Mainland China, the rate of Chinese withholding tax can be reduced from 10% to 5% for substantive equity participations. Also as Hong Kong is a source based jurisdiction, profit repatriated from overseas can be received tax free in Hong Kong affording global businesses the opportunity to maximize profitability by efficiently retaining the profits in the Holding Company for funding global or regional operations.

The Holding Company can also house other operations of the group, such as back office functions, management and the co-ordination of international trade in return for arm's length compensations which are taxed at a competitive rate in Hong Kong, currently 16.5%.

This consolidation of return on capital and other compensations in one Holding Company provides an excellent opportunity for a group to manage the Holding Company also as a Treasury Company. Hong Kong only taxes profits sourced in Hong Kong. The source of interest income accruing to non financial institutions in Hong Kong is determined as the place at which the funds or credits are first made available by the lender to the borrower. This is the so-called "provision of credit test". Accordingly, situating a Treasury Company in Hong Kong managing funding for regional or global business, if properly structured, can result in favorable tax arbitrage, with interest expenses setting against income at higher tax rates and corresponding interest income in the accounts of the Treasury Company not subject to tax in Hong Kong. As a word of caution, if the Treasury Company does have a need for external funding, different strategies may be necessary to maintain tax efficiencies.

Thus this business model entails the set up of a Holding and Treasury Company in Hong Kong with a function mix capable of producing tax efficient profit repatriations, returns on capital, and compensations for active services and provision of credits.

Substance, Employment and Business Effectiveness

Many jurisdictions including China apply stringent tests to ensure tax treaty benefits are only made available to nonresident companies with business substance, as opposed to companies with no substantive operations used merely as conduit for routing funds and profits. We would therefore once again emphasize a business model based only upon tax efficiencies can never be sound as an effective business model must reflect the operational and commercial needs of the business and, as importantly, it must be run by effective and competent people.

Hong Kong has a huge, multi lingual talent pool, comprising a work force skilled in financial analysis, accounting, financial risk management, treasury functions as well as outstanding management skills. They are anxious to secure jobs that allow them to fulfill their true potential. Global businesses establishing Holding and Treasury Company in Hong Kong can rely on this highly motivated and experienced workforce to ensure the results they anticipate can be well delivered.