TR 97/19 - Income tax: tax implications of resumption of Chinese sovereignty over Hong Kong

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Taxation Ruling
Income tax: tax implications of resumption of Chinese sovereignty over Hong Kong

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*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to Australian residents who derive income from sources in Hong Kong or who have interests in controlled foreign companies (CFCs) which are residents of Hong Kong for the purposes of the foreign source income (FSI) measures. It also applies to residents of Hong Kong who derive income from sources in Australia.

2. It is not the purpose nor intent of this Ruling to determine whether particular persons are residents of Hong Kong.

Ruling

3. The operation of the Australia-China Double Taxation Agreement (DTA) does not extend to the Hong Kong Special Administrative Region following resumption of Chinese sovereignty over the territory on 1 July 1997. It follows that the DTA does not apply to residents of Hong Kong following the handover, nor to income derived by Australian residents from sources in Hong Kong.

4. For FSI purposes, Hong Kong will continue to be treated as an 'unlisted country'. The resumption of Chinese sovereignty does not therefore give rise to the operation of section 457 of the *Income Tax Assessment Act 1936* (ITAA).

Date of effect

5. This Ruling applies to the 1997-98 or a later income year.

Explanations

Background

6. When Chinese sovereignty over Hong Kong resumed on 1 July 1997, a Hong Kong Special Administrative Region (SAR) was established in accordance with the *Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the question of Hong Kong*. The Joint Declaration, which was made on 30 June 1985, stated, *inter alia*, that the Hong Kong SAR will have independent finances and that:

> 'The Central People's Government shall not levy taxes on the Hong Kong Special Administrative Region. The Hong Kong Special Administrative Region shall use its financial revenues exclusively for its own purposes and they shall not be handed over to the Central People's Government. The systems by which taxation and public expenditure must be approved by the legislature, and by which there is accountability to the legislature for all public expenditure, and the system for auditing public accounts shall be maintained.'

7. In 1990, the National People's Congress of China enacted *The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China* (the Basic Law)(adopted on 4 April 1990) prescribing the legislative systems to be practised in the Hong Kong SAR.

8. Article 106 of the Basic Law provides that:

> 'The Hong Kong Special Administrative Region shall have independent finances.
>
> The Hong Kong Special Administrative Region shall use its financial revenues exclusively for its own purposes, and they shall not be handed over to the Central People's Government.
>
> The Central People's Government shall not levy taxes in the Hong Kong Special Administrative Region.'

9. Article 108 of the Basic Law provides:

> 'The Hong Kong Special Administrative Region shall practise an independent taxation system.
>
> The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax

reductions, allowances and exemptions, and other matters of taxation.'

10. Article 8 of the Basic Law provides that the laws in force in the Hong Kong SAR shall be the Basic Law, the laws previously in force in Hong Kong as provided for in Article 8 of the Basic Law, and the laws enacted by the legislature of the Region. According to Article 18 of the Basic Law, national laws shall not be applied in the Hong Kong SAR except for those listed in Annex III to the Basic Law, which shall be confined to those relating to defence and foreign affairs as well as other matters outside the limits of the autonomy of the Region.

The issues

11. This Ruling examines two related issues that arise from the resumption of Chinese sovereignty over Hong Kong.

12. The first issue relates to Hong Kong becoming an SAR of China and the implications that this has for the operation of the existing Australia-China DTA. The issue turns on whether or not, for purposes of the DTA, 'China' (as defined in subparagraph (1)(b) of Article 3 of the DTA) extends to the Hong Kong SAR.

13. The second issue concerns the position under Australia's FSI measures of CFCs that are residents of Hong Kong, and in particular whether section 457 of the ITAA has any application as a result of the handover. Broadly, section 457 provides that where a CFC changes residence from an 'unlisted country' (such as Hong Kong) to a 'listed country' (such as China) then an amount is included in a taxpayer's assessable income.

Australia-China DTA

14. The first issue concerns the interpretation of the DTA that applies to persons who are residents of China (or Australia) and operates to relieve double taxation that may arise in relation to income taxes imposed in China (and Australia). This Ruling considers whether, after the handover, the DTA extends to Hong Kong.

15. On Hong Kong becoming a Special Administrative Region of the People's Republic of China on 1 July 1997, the general rule of international law concerning the succession of states where a state acquires or resumes sovereignty over territory would ordinarily operate to extend the application of China's existing treaties to Hong Kong. This general rule is, however, subject to any contrary intention that may appear in, or in relation to, a particular treaty. The rule is reflected in Article 29 of the *Vienna Convention on the Law of Treaties between States and International Organizations or between*

International Organizations that provides that 'Unless a contrary intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory'.

16. Article 153 of the Basic Law allows for the extension to Hong Kong post-30 June 1997 of international agreements to which the People's Republic of China is a party:

> 'The application to the Hong Kong Special Administrative Region of international agreements to which the People's Republic of China is or becomes a party shall be decided by the Central People's Government, in accordance with the circumstances and needs of the Region, and after seeking the views of the government of the Region.
>
> International agreements to which the People's Republic of China is not a party but which are implemented in Hong Kong may continue to be implemented in the Hong Kong Special Administrative Region. The Central People's Government shall, as necessary, authorize or assist the government of the Region to make appropriate arrangements for the application to the Region of other relevant international agreements.'

17. To date, the Central People's Government has not made any official pronouncement in relation to China's double taxation agreements. However, it is our view that, by reason of the definition of 'China' in the DTA, the application of the Australia-China DTA does not extend to Hong Kong.

18. 'China' is defined in subparagraph (1)(b) of Article 3 of the DTA in the following terms:

> ' ... the term "China" means the People's Republic of China and, when used in a geographical sense, it means all the territory of the People's Republic of China, including its territorial sea, **in which the laws relating to Chinese tax apply**, and any area beyond its territorial sea, within which the People's Republic of China has sovereign rights of exploration for and exploitation of resources of the seabed and its subsoil and superjacent water resources in accordance with international law.' (emphasis added)

19. Thus, the geographical area of China in which the DTA has application is limited, so far as is relevant, to the territory of the People's Republic of China in which the laws relating to Chinese tax apply.

20. 'Chinese tax' is defined in subparagraph (1)(i) of Article 3 as meaning 'tax imposed by China, being tax to which this Agreement applies by virtue of Article 2'. For the reasons set out below in relation to ***Taxes covered***, it is our view that 'Chinese tax' does not

include taxes imposed by the Hong Kong SAR and, since Article 106 of the Basic Law provides that the Central People's Government shall not levy taxes in Hong Kong, we consider that 'the laws relating to Chinese tax' do not apply in the Hong Kong SAR.

21. Thus, for purposes of determining the geographical scope and application of the DTA, 'China', as defined in the DTA, does not extend to the Hong Kong SAR. The DTA does not, therefore, apply to residents of Hong Kong or to taxes imposed by the Hong Kong SAR. These issues are discussed in more detail below.

i) Taxes covered

22. Article 2 provides that the existing taxes to which the DTA applies are:

> '(b) in China:
>
> the income tax imposed under the laws of the People's Republic of China.'

23. Paragraph (2) of Article 2 extends the application of the DTA to 'any identical or substantially similar taxes that are imposed after the date of signature of this Agreement in addition to, or in place of, the existing taxes'.

24. The Basic Law provides that the Hong Kong SAR shall practise an independent taxation system and enact laws on its own on taxation matters (Article 108). Clearly, the DTA would extend to the new tax regime administered by the Hong Kong SAR only if those taxes are 'identical or substantially similar' to the existing taxes imposed by the Central People's Government of China.

25. In accordance with Article 108, Hong Kong SAR taxes are expected to continue to adopt the low tax policy previously pursued in Hong Kong. The taxes are imposed by the Hong Kong SAR and not the Central People's Government, and the new laws currently follow the same territorial basis and low taxing rates that previously existed in Hong Kong. Accordingly, it is not accepted that the Hong Kong SAR taxes would be 'identical or substantially similar' to the taxes currently imposed in China to which the DTA applies.

26. It follows that the DTA does not apply to taxes imposed by the Hong Kong SAR.

ii) Residence

27. In accordance with Article 1 (*Personal Scope*), the DTA shall apply to persons who are residents of one or both of the Contracting

States. By subparagraph (1)(d) of Article 3 the term 'person' includes an individual, a company and any other body of persons.

28. Under paragraph (1) of Article 4 (*Residence*) of the DTA, the term 'resident', in relation to a Contracting State, means a person who is fully liable to tax therein by reason of being a resident of that State under the tax law of that State.

29. Notwithstanding the resumption of Chinese sovereignty over Hong Kong on 1 July 1997, the territory of China to which the DTA applies does not include the Hong Kong SAR, and Chinese tax laws do not apply in the Hong Kong SAR. It follows that a person who is a resident of Hong Kong is not fully liable to tax in China by reason of being a resident of China under Chinese tax laws, and is not, in relation to China, a resident for purposes of the DTA.

30. Accordingly, residents of Hong Kong do not come within the scope of the Australia-China DTA.

iii) Source

31. Because the territory in which the Australia-China DTA applies does not include the Hong Kong SAR, the provisions of the DTA do not apply to income arising in Hong Kong.

FSI measures

32. This Ruling also considers whether, for the purposes of Australia's FSI measures, a change of residence will be taken to have occurred in relation to controlled foreign companies (CFCs) of attributable taxpayers by reason of the resumption of Chinese sovereignty over Hong Kong.

33. Broadly, subsection 457(1) of the ITAA provides that where a CFC of an attributable taxpayer ceases to be a resident of an 'unlisted country' and becomes a resident of a 'listed country' or a 'Part X Australian resident' then an amount calculated under subsection 457(2) is included in the attributable taxpayer's assessable income in the year of income in which the change of residence occurs.

34. Hong Kong has been treated as an 'unlisted country', while China is a 'listed country'. When China resumed sovereignty over Hong Kong the question arose whether Hong Kong would thereby become a 'listed country' for FSI purposes.

35. Section 320 of the ITAA sets out the provisions for determining whether a foreign country, or part of a foreign country, is to be treated as listed or unlisted for FSI purposes. Subsection 320(4) provides:

> 'For the purposes of this section, if, apart from this subsection, one or more parts of a particular foreign country are excluded (either expressly or by implication) from the operation of a double tax agreement in force in relation to the foreign country, the part or parts so excluded are to be taken to constitute a separate foreign country.'

36. Notwithstanding the resumption of Chinese sovereignty, Hong Kong is, for the reasons expressed above, excluded from the operation of the Australia-China DTA. Hong Kong is, therefore, deemed by reason of subsection 320(4) to be a 'separate foreign country' that, since it is not specified in Schedule 10 of the Income Tax Regulations, is an 'unlisted country' as defined in subsection 320(1). The Treasurer also announced in the 1997 Budget that amendments would be made to ensure that Hong Kong would continue to be treated as an unlisted jurisdiction following the establishment of the Hong Kong SAR.

37. It follows that the resumption of Chinese sovereignty over the Hong Kong SAR does not give rise to a change of residence for purposes of section 457.

Example

38. An attributable taxpayer with an interest in a CFC that is a resident of Hong Kong as at 30 June 1997 and who retains that interest post-30 June 1997 will not be subject to the provisions of section 457 in respect of that CFC by reason of China's resumption of sovereignty over Hong Kong.

Alternative view

39. The alternative view is that the taxes imposed by the Hong Kong SAR are Chinese tax laws that are identical or substantially similar to the existing taxes imposed by the People's Republic of China. If this is the case, then Hong Kong taxes are taxes to which Article 2 applies and are therefore 'Chinese tax' as defined in subparagraph (1)(i) of Article 3, with the result that Hong Kong would be considered as part of the territory of China in which the laws relating to Chinese tax applies.

40. However, this view is not accepted by the ATO, nor has it been proposed to Australia by the Chinese tax authorities.

41. In any event, even if the alternative view is correct, a resident of Hong Kong would not be a resident of China under the DTA by reason of paragraph (2) of Article 4. This paragraph provides that a person is

not a resident of a Contracting State for the purposes of the DTA if the person is liable to tax in that State in respect only of income from sources in that State. Even if Hong Kong is considered to be subject to Chinese tax for DTA purposes, since residents in the Hong Kong SAR would be taxable only on income from sources in Hong Kong, paragraph (2) of Article 4 would operate to exclude them from the definition of resident of China for DTA purposes. They would not, therefore, be entitled to treaty benefits.

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