

A TAX TREATY BETWEEN FRANCE AND HONG KONG: SOON TO BE A REALITY

Hong Kong has adopted a reform of its legislation concerning the exchange of information at the international level which suggests the conclusion of a tax treaty between France and Hong Kong.

Although Hong Kong, one of the world's leading financial markets, has a rudimentary tax treaty network, the legislative modifications of 2010 could well change matters and allow European countries, including France, to benefit from the advantages relating to the conclusion of treaties intended to prevent double taxation.

I. THE REFORM OF HONG KONG LEGISLATION: PAVING THE WAY FOR NEW BILATERAL TAX TREATIES

- A necessary reform

In the current international fight against tax avoidance, Hong Kong had to reform its local laws quickly in order to facilitate the exchange of tax information. Singapore, its main competitor, had already modified its national legislation at the end of 2009 and signed protocols/amendments with more than 12 of its trading partners, thereby evading inclusion on the OECD's grey list (this list contains countries that have undertaken to abide by OECD standards but that have not yet substantially implemented them). This reform took place in Hong Kong on 12 March 2010, with the entry into force of the Inland Revenue (Amendment) Ordinance No. 1 of 2010.

- The innovation: a broader yet controlled exchange of information

From now on, upon receiving an information request from the tax authorities of another State, the Hong Kong authorities will have powers to investigate even if they do not require the information requested for their own tax purposes. However, certain restrictions will apply to this exchange of information: (i) a double taxation treaty must have been concluded with the State in question, (ii) the information request must concern a tax coming under the scope of the exchange of information clause, and (iii) the exchange of information must correspond to a detailed request of the foreign authorities and may be neither spontaneous nor automatic.

In addition, the reform should not be "retroactive": no information concerning periods prior to the entry into effect of new tax treaties may be disclosed. This reform requires an adaptation of existing treaties since the exchange of information clause was initially drafted on the basis of the 1995 OECD model.

- Safeguards to protect taxpayers

In addition to the safeguard measures contemplated by the OECD model (concerning, in particular, confidentiality obligations and what the information may be used for), special measures have been adopted to protect the rights of the taxpayers to whom the information requests relate [Inland Revenue (Disclosure of Information) Rules adopted on 3 March 2010]. Hong Kong is also expected to issue soon a Departmental Interpretation and Practice Note ("DIPN") on the safeguard procedures to be followed by Hong Kong's tax authorities in relation to the exchange of information.

Pursuant to these measures, persons concerned by the disclosure request must be informed of the existence of a request

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by the foreign authorities. They will be able to obtain a copy of the information transmitted and may request that wrong information be rectified (being observed that taxpayers in France do not benefit from this safety). However, exceptions to this preliminary notification requirement are envisaged by Hong Kong in certain situations (invalid address, urgent request, etc.), subject to justification, and the Hong Kong tax authorities would retain the right to refuse requests to correct information (the persons concerned may bring an appeal against this refusal).

In addition, only “foreseeably relevant” information may be requested by the foreign authorities in order to avoid abuse (known in legal jargon as “fishing expeditions”). In particular, the request for information will have to contain:

- (i) the identity of the foreign authority making the request and that of the person concerned,
- (ii) a description of the purpose of and reasons for the request,
- (iii) the ground for believing that the information requested is held by an authority or person in Hong Kong,
- (iv) the name and address of the person believed to have possession of this information,
- (v) the type of tax and the period concerned,
- (vi) the reply deadline, and also,
- (vii) a statement that the disclosure request complies with local legislation and that all domestic procedures were pursued before submitting the request.

- Direct consequences for the conclusion of tax treaties

Before this reform, Hong Kong had only signed five double taxation treaties: with Belgium (in 2003), Thailand (in 2005), the People's Republic of China (in 2006), Luxembourg (in 2007) and Vietnam (in 2008). Thanks to its improved tax transparency, Hong Kong has signed in March 2010 three new tax agreements (with Brunei, The Netherlands and Indonesia) and is now able to finalize the negotiations initiated several years ago for the conclusion of tax treaties (in particular with the United Kingdom, France, Italy, Ireland and Spain). Hong Kong has every interest in doing so, because the extension of its network of treaties will facilitate international exchanges with its economic partners thanks to fewer tax leakages and the greater security of commercial and financial flows

II. ADVANTAGES OF A TAX TREATY – FOCUS ON INTERNATIONAL TRADE BETWEEN HONG KONG AND FRANCE

Negotiations between Hong Kong and France started in September 2003, but were suspended in 2004 owing to Hong Kong's inability to adopt the 2004 version of the OECD model with respect to the exchange of information (2004 OECD standards were inconsistent with Hong Kong legislation at that time). Begun again in October 2009 shortly after the announcement of the modification of Hong Kong legislation, the negotiations with France are now in their final stages. From a practical point of view, the imminent conclusion of a tax treaty between Hong Kong and France should benefit all French and Hong Kong economic players, and thus promote reciprocal investment in the two countries, by reducing the risks of double taxation for companies as well as private individuals and allowing French and Hong Kong investors to better evaluate their effective tax rate. The entry into force of such a treaty could also allow the various players to limit the negative tax impacts relating to the French anti-abuse mechanisms.

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- The elimination of tax disagreements that hinder trade between France and Hong Kong

o Allocation of taxation rights

Unlike most other States, France and Hong Kong have adopted a territorial system for the taxation of profits. Consequently, in theory, situations in which companies incur double taxation of their profits should be limited. However, in practice, these risks are quite real, particularly since the notion of “tax residence” is not clearly defined in Hong Kong and the fact that uncertainties exist concerning the concept of “Hong Kong source profits” whose acceptance by Hong Kong’s tax authorities is spreading. A tax treaty between France and Hong Kong will certainly offer greater security to French investors in Hong Kong (and to Hong Kong players in France) by removing such ambiguities.

o Abolition or reduction of withholding taxes

A tax treaty between France and Hong Kong would doubtless provide for a reduction in (or even the abolition of) withholding taxes. Although no tax is currently withheld by Hong Kong in respect of dividends paid to a parent company located in France, in the opposite direction, dividends paid by a French subsidiary to a Hong Kong parent company are subject to a withholding tax of 25% in France. Such tax currently constitutes an outright loss for the parent company in Hong Kong because it cannot deduct it from its taxable income.

As regards royalties, the conclusion of a tax treaty should benefit both Hong Kong investors (because France applies a withholding tax of 33.33% to royalties) and French companies investing in Hong Kong, since certain royalties (in particular those paid under intellectual property licenses) are subject in Hong Kong to a withholding tax of 16.5% on payments between companies of the same group, or to an effective rate of 4.95% in other cases.

Concerning interest flows, neither Hong Kong nor France (since 1 March 2010) currently provides for taxation at source. The conclusion of a tax treaty could however be of benefit in the future should Hong Kong become regarded by France as a “non-cooperative” country (this is very unlikely however – see our comments below).

As concerns capital gains, certain profits on transfers of ownership interests in France (shares, equity interests, etc) made by investors Hong Kong are currently taxed in France at 18%; however, this taxation could be limited or abolished by the conclusion of a tax treaty.

o Abolition or reduction of double taxation in relation to transfer pricing adjustments

When the tax authorities reassess the taxable income of a French company following a transfer of profits to a related entity located in Hong Kong, Hong Kong currently refuses to grant a correlative adjustment because of the absence of a tax treaty. The conclusion of a tax treaty should thus afford greater security for the transfer pricing policy of international groups that locate part of their profits in Hong Kong since this agreement will probably provide for an offset mechanism in the event of a transfer pricing readjustment and the introduction of a mutual agreement procedure in the event of difficulties of interpretation of this mechanism. The adjustment offered by the Hong Kong legislation on the basis of the treaty will not be systematic however: the tax Hong Kong authorities will still be able to refuse the adjustment if they consider that the adjustment carried out in France is not sufficiently justified in its principle or its amount, or if

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one of the entities concerned by the adjustment is in a tax loss position (Hong Kong does not recognize the existence of double taxation in this last case).

On the Hong Kong side, the risks of a reassessment following a transfer pricing readjustment are more limited given the lower tax burden in this territory and the absence of specific regulations. This risk exists nevertheless in the case of French groups which try to locate part of their Hong Kong profits in French entities that are operating structurally at a loss. In this respect, it should be noted that Hong Kong's local authorities are paying greater attention to the subject of transfers of profits. Proof is given by the recent publication of the DIPN 46 note which specifies the methodology to be followed when evaluating arm's length principles in relation to transfer pricing.

- Limitations of certain French anti-avoidance mechanisms?

- o Hong Kong is not on the French black list of "non-cooperative" countries

France is one of the first States to have reinforced its internal mechanisms to tackle tax havens, as shown by the introduction into the French tax system of the concept of "non-cooperative" States (new article 238-OA of the French Tax Code - "FTC"), for which particularly restrictive concrete measures have been implemented in order to dissuade French firms from doing business with such States (including the abolition of the parent-subsidiary regime as from 1 January 2011, and an increase in the withholding tax rates in France to 50%).

Hong Kong is not on the French black list which was published on 12 February 2010. The willingness displayed in recent months by Hong Kong to conform to the OECD's international standards in relation to tax transparency and the exchange of information (chiefly characterized by the modification of its legislation), as well as the geostrategic role and influence of Hong Kong, are factors that contributed to this decision. It should be remembered however that this list is updated on the 1st of January of each year. Hong Kong's non-inclusion on the black list will thus depend not only on the conclusion of a tax treaty with France comprising an administrative assistance clause, but mainly on its cooperativeness in relation to the exchange of information.

- o Towards a neutralization of French anti-abuse measures

Although Hong Kong is not on the French black list of "non-cooperative" countries, France still regards it as having a privileged tax regime, which could lead to the application of anti-avoidance measures. As long as the level of taxation remains low in Hong Kong, a tax treaty with France could make it possible to reduce the tax exposure of French investors in Hong Kong.

A tax treaty between Hong Kong and France could indeed eliminate the risk of the application of article 209B of the FTC, which subjects the profits of branches and subsidiaries in which a French company holds a stake of more than 50% to corporate income tax in France, if these entities are located in low-tax country and do not provide proof of any truly industrial or commercial activity carried on locally. However, only a thorough reading of the final text of the treaty will clarify this point. Given the current political climate that favors the fight against tax avoidance, France will doubtless wish to adopt a treaty that allows it to apply article 209 B. However, Hong Kong, which does not wish to be perceived as a tax haven, could also take advantage of the double taxation treaty to favor French investments on its terri-

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tory by rejecting the application of this mechanism (France could then obtain information on the activities of subsidiaries and branches under the exchange of information clause).

The entry into effect of a tax treaty between France and Hong Kong could also limit the scope of article 123 bis of the FTC that provides for the levying of personal income tax in France on profits made by foreign entities located in territories having a privileged tax regime (such as Hong Kong) in which a stake of more than 10% is held by individuals residing in France, whose assets are primarily financial or monetary. Although a tax treaty between Hong Kong and France would not disable this mechanism, the inclusion of an administrative assistance clause in the treaty would nevertheless make it possible, in certain cases, to reduce the tax burden in France.

In addition, if the treaty concluded between France and Hong Kong contains an administrative assistance clause in order to combat fraud and tax avoidance, legal entities in Hong Kong that hold (directly or via an intermediate entity) property in France or rights in rem to such property may be able to evade the annual 3% tax on the market value of such property or rights (pursuant to article 990 E of the FTC). This exemption will be subject however to an undertaking to communicate certain information to the tax authorities, if requested, including the identity and address of certain of their shareholders.

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