One country, two systems, zero tax

Thesis Master Asian Studies: Politics, Society and Economics
Thesis supervisor: Dr. Rogier Creemers

Sietze Sybesma
S1291483
Words: 16010

Table of contents

List of abbreviations .... - 2 -

Introduction .... - 3 -

Chapter 1. Methodology .... - 6 -

Chapter 2. Business profits .... - 9 -

2.1. General rules and regulations .... - 9 -

2.2. Income from immovable property .... - 11 -

2.3. Permanent Establishment .... - 12 -

2.3.1. Special PEs .... - 12 -

THE SVETLOGORSK CASE .... - 14 -

2.4. Concluding remarks .... - 17 -

Chapter 3. Investment income .... - 18 -

3.1. Dividends .... - 18 -

3.1.1. General rules and regulations .... - 18 -

3.1.2. Beneficial Owner and Safe Harbor rule .... - 20 -

3.1.3. The Controlled Foreign Companies (CFC) rule .... - 22 -

THE SHANDONG CASE .... - 23 -

THE COGOGL CASE .... - 24 -

3.1.4. Conclusion .... - 26 -

3.2. Interest .... - 26 -

THE BRITISH VIRGIN ISLANDS CASE .... - 29 -

3.3. Capital gains .... - 31 -

3.4. Conclusion .... - 33 -

Chapter 4. Conclusions .... - 35 -

Bibliography .... - 39 -

Double Tax Agreements used for the DTA sets .... - 46 -

List of abbreviations

BEPS	Base Erosion & Profit Shifting
BO	Beneficial owner
BVI	British Virgin Islands
CAMCE	China CAMC Engineering
CFC	Controlled foreign company
CNOOC	China National Offshore Oil Corporation
COFCO	China Oil and Foodstuffs Corporation
COGOGL	China Overseas Grand Ocean Group ltd.
DTA	Double tax agreement
EITL	Enterprise income tax law
GAAR	General Anti-Avoidance Rule
OECD	Organization for Economic Cooperation and Development
PE	Permanent Establishment
SASAC	State-owned Assets Supervision and Administration Commission
SOE	State-owned enterprise

Introduction

The aim of this thesis is to investigate how a Hong Kong enterprise can help Chinese state-owned enterprises (SOE) lower the tax burden related to profits sourced from its overseas assets. I will focus on Chinese SOEs because they often place their overseas assets in a Hong Kong subsidiary.[1] Under projects such as the Going Global Strategy[2] and the Belt-Road Initiative,[3] Chinese SOEs have been encouraged by the Chinese government to invest abroad. Over the years, thanks to low interest rate loans from state banks and other protection measures,[4] the SOEs accumulated 6 trillion Renminbi in overseas assets in around 189 countries and regions. These assets account for 11% of the assets owned by SOEs, which total 50.5 trillion Renminbi.[5] Some of these overseas assets are managed from a Hong Kong subsidiary.

Why do some Chinese SOEs use a Hong Kong subsidiary? This subsidiary can be important for many reasons, such as access to financial markets and trade.[6] However, Hong Kong subsidiaries can also be very beneficial for tax reasons,[7] as they make it possible to lower or entirely avoid taxation.[8] Planning taxes in a way that no taxes need to be paid is harmful. It is harmful to governments because they have less money to fund public services it is harmful to businesses which meet with unfair competition when their competitor does not pay taxes and to citizens because they have to pay more taxes to compensate for the tax losses.[9] In 2017, the Organization for Economic Cooperation and Development (OECD) estimated that the global annual corporate tax loss is 100 to 240 billion US dollars.[10] Furthermore, an estimated 6.3 trillion to 36 trillion US dollars is accumulated in tax havens, where it often remains untaxed.[11]

[1] Avi-Yonah & Xu Haiyan (2018), p. 2
[2] Shambaugh (2013), p. 138
[3] Yao Xinyu (2015)
[4] Shambaugh (2013), p. 127 the Chinese state banks gave loans with low interest rates to SOEs.
[5]央企 Yāngqǐ (2017-10-26); Ministry of Commerce (2018), p. 3; Rotblat (2018), p. 106; SASAC 国务院国资委(Guówùyuàn guózī wěi) (2017)
[6] Observatory of Economic Complexity (Hong Kong) (2020): Hong Kong imports 42% (worth 255 billion US dollars) from China. 11% (worth 265 billion US dollars) of China’s total exports goes to Hong Kong; Observatory of Economic Complexity (China) (2020)
[7] Government of Hong Kong (2020)
[8] Cui Wei (2015), p. 14. Chinese SOEs are subject to the Chinese Enterprise Income Tax.
[9] European Commission (n.d.); OECD (2014)
[10] OECD (2017)
[11] Zucman (2015), p. 49; International Monetary Fund (2019)

In order to combat tax avoidance, the OECD started in 2013 with the Base Erosion Profits Shifting (BEPS) project.[12] Although China is not a member of the OECD, it has a positive attitude towards the implementation of this project in China,[13] as it is a victim of tax avoidance and has mentioned the loss of tax income due to tax avoidance as a 'major threat'.[14] China's positive attitude is remarkable, considering that China's own SOEs also own subsidiaries in offshore tax havens,[15] and considering the well-documented fact that Hong Kong is used as an intermediary to channel capital from China to tax havens.[16] It becomes even more remarkable, once we realize that these tax havens are linked to numerous Chinese Communist Party officials holding leading positions in the SOEs[17] and that these officials use the tax havens for transactions classified as corruption according to an official report from the Central Bank of China.[18]

I assume that the money channeled from China to the tax havens is at least taxed in China before it is channeled out. But it is not known if profits sourced from the SOEs's overseas assets in other countries (whether managed by a Hong Kong subsidiary or not) are taxed there, in China or in Hong Kong. It is possible that profits are not taxed in the source country, and via Hong Kong end up in a tax haven, entirely untaxed. Considering the value of the overseas assets, the total value of the profits that remain untaxed could be huge.

Interestingly, as far as I have been able to find out, nothing has been written about the interaction of the tax laws of Hong Kong and those of China, and the role of Hong Kong in Chinese SOEs. Much has been written about the Hong Kong or Chinese tax system or the taxation of SOEs, but I have not found any publication about the synergy of these two tax systems and Chinese SOEs, even though it would be interesting to see what kind of tax benefits a Hong Kong subsidiary can gain for a Chinese SOE. That is the reason why I want to find out how Hong Kong can be used to gain tax benefits for SOEs on profits derived from overseas

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[12] OECD (2014)
[13] Xu Diheng (2018), p. 473-474
[14] United Nations (2014); Zheng Yangpeng (2016-05-14); China ratifies intl pact against tax avoidance (2015-07-01)
[15] Qiu Dongmei (2014), p. 649; Wilson (2013), p. 209: This article gives a reason to own a British Virgin Island subsidiary, namely the access to the United Kingdom's legal system.
[16] Qiu Dongmei (2014), p. 651; Avi-Yonah & Xu Haiyan (2018), p. 2
[17] The State-owned Assets Supervision and Administration Commission (SASAC) has the right to appoint the leadership of the SOEs. The appointed leaders are effectively always CCP members; ICIJ (2014-01-24)
Wu Wendy (2017-06-17); Rotblat (2018), p. 102
[18] 中国人民银行 Zhōngguó rénmíng yínháng. [People's Bank of China] (2008), p. 7-34. In 2006 an estimated 800 billion Renminbi went missing.

assets. Another part of this question is to what extent that tax benefit is based on a coincidence or not?

In this thesis, I cannot consider all types of taxation and assess to what extent tax benefits can be gained. I will focus on the business profits and investment income. To illustrate the actual practice of how Chinese SOEs and their Hong Kong subsidiaries interact, I present a number of case studies. The case studies are based on primary sources such as official documents from different governments, the Chinese and Hong Kong tax laws and annual reports from SOEs. By relying on these primary sources, I expect to be able to find objective evidence which will enable me to show whether a tax benefit can be gained by having a Hong Kong subsidiary. These case studies will furthermore clarify the workings of the Chinese and Hong Kong tax laws and how they interact with the General Anti-Avoidance Rules (GAAR) and double tax agreements (DTA).

This thesis is organized as follows. In the first chapter I explain the methodology which I employed for the research. I give more information on the case studies, I explain why DTAs are important for this thesis and how they work. Finally, I pay some attention to the GAARs. In the second chapter I discuss business profits, while the third chapter is devoted to investment income. In the conclusion I give a short summary of this thesis, highlighting the most important findings, and explain what kind of tax benefits Hong Kong subsidiaries can gain for Chinese SOEs.

Chapter 1. Methodology

To find out if a Hong Kong subsidiary can help lower taxation, I need to have a benchmark to relate the taxation to. As a benchmark I will take the situation as it would have been if the overseas assets had been directly owned by a Chinese resident enterprise. I will also focus on the applicable DTAs and GAARs and the possible benefits they can create. A DTA has impact on the deduction of costs, the time thresholds for construction projects, the right to tax and the withholding tax rates. A GAAR aims to make certain tax avoiding practices impossible. By analyzing the relevant DTA's and GAARs, we will understand where tax benefits may arise and what the scope of these benefits may be. We can then also see whether tax benefits we encounter in our case studies are systematic benefits or incidental benefits (more on this below). Taking all these factors into consideration, we will be able to determine whether a Hong Kong subsidiary can be profitable in terms of tax benefits for a Chinese SOE.

Due to time and space constraints I can only focus on two categories of taxation. The first category is the taxation of business profits from regular business and special cases such as permanent establishments and immovable properties. The second category is the taxation on investment income, such as interest, dividends and capital gains.[19] I chose these two categories because the former category is primarily concerned with the taxation on profits in overseas assets, while the latter category is concerned with the taxation on capital flowing from the overseas assets to the enterprise. In other words, the former category is relevant for the overseas assets owned by SOEs and the latter is relevant because it concerns the shift of capital from the overseas assets to the SOEs. Another important reason for choosing these two categories of taxation is that they are covered by DTAs, which will be explained later.

As mentioned above, one of the sources I used in reconstructing the case studies that will illustrate the workings of the different mechanisms are corporate annual reports from the SOEs themselves. In most cases the annual reports do not contain all the information I needed and that is why I also used filings by the Chinese SOEs in question at governmental bureaus, such as the US Securities and Exchange Commission and the Hong Kong Securities & Futures Commission.[20] Unless stated otherwise, for reasons of consistency and reliability, the

[19] Arnold (2016), p. 24-26

[20] Both organizations are governmental financial supervisors of the United States of America and Hong Kong.

transactions such as loans or dividend payments are reconstructed solely on the basis of the annual reports and filings of the corporations. In some cases, I used other sources as well, such as news reports, in-company PowerPoint presentations and governmental websites, to add more details to case studies if that was necessary.

All the cases presented in this thesis have been reconstructed by me, except for the corporate structure used in the Shandong case, which is based on an article from the Shandong Province Revenue Service. Also, in the studies, only the important entities have been mapped. As a kind of disclaimer, I would like to emphasize, that, because no complete corporate structure of the corporations I was interested in is available online, I cannot guarantee that the corporate structures as presented here are entirely correct. However, as mentioned above, I primarily relied on sources from the corporations themselves to piece the structures together. In other words, the information is to be considered correct, even if it is not complete.

As I mentioned earlier on, one of the goals of this thesis is to find out how often tax avoidance by way of using a Hong Kong subsidiary occurs. This way we can determine whether benefits gained are just incidental or systematic. I will use two methods to assess whether the tax benefit is incidental or not. The first method is to assess whether a Chinese GAAR is effective to counter the tax benefit. For instance, with a GAAR, it is possible to tax overseas profits, which under normal circumstances cannot be taxed under Chinese law, and if a GAAR can potentially counter a certain tax practice, I will assess if it is an effective rule by looking at the requirements for the application of the GAAR. These requirements are published by Chinese governmental bodies in all sorts of official documents, such as announcements (*gonggao*), interpretations of policies (*zhengce jiedu*), State tax letters (*guoshuihan*) and circulars (*caishui*). Because, when it comes to the requirements of a GAAR, these official documents are more important than the Enterprise Income Tax Law (EITL), I will only use these official documents in assessing the effectiveness of a GAAR. A GAAR is effective if it can be used to tackle a certain tax practice.

The second method I will use to assess whether a certain tax benefit is incidental or not, is to check whether a tax benefit gained by a DTA is a coincidence or not. For this the benefits that can arise from a DTA will be addressed and analyzed. Basically, a DTA is a binding agreement

between two countries.[21] It is possible that a DTA signed between a third country and Hong Kong can have a different content than the DTA signed between the same third country and China. Potential differences in content may be different withholding tax rates between the same third country and China and Hong Kong, the Chinese or Hong Kong right to tax capital gains sourced from third countries and different deductions of expenses and threshold durations of a DTA (depending on whether the OECD version was used or the UN version). Most DTAs are based on the standard model DTA of the OECD or the one from the UN, and both sets come with their own commentary and explanation of terms used in the DTA. The OECD and the UN model DTA generally follow the same layout, but some differences in content exist.[22] It should be clear that a DTA can give a company tax benefits, but it should also be assessed whether such a tax benefit is a coincidence or not. That is the reason why I will analyze all DTAs (72 DTAs in total) signed between Hong Kong and third countries and DTAs signed between China and the same third countries. All except 3 DTAs signed with Hong Kong are taken into consideration here.[23]

[21] Arnold (2016), p. 3
[22] United Nations (2018), p. xvii
[23] Hong Kong signed DTAs with three countries (Jersey, Guernsey and Liechtenstein) China did not signed a DTA with.

Chapter 2. Business profits

In this chapter, I investigate the question whether having a Hong Kong subsidiary can lead to tax benefits with respect to business profits and profits from special cases, such as permanent establishments and immovable properties. I will show what the tax benefits from business profits are by comparing the relevant tax rates of China with those of Hong Kong. I will explain the role DTAs play in the taxation of business profits. The last part of this chapter will be devoted to the applicable GAAR. This will all be illustrated using two case studies which clearly show the difference between a Hong Kong subsidiary and a Chinese one.

2.1. General rules and regulations

The income tax rates on business profits in China and Hong Kong are different. The Chinese standard rate is 25%.[24] Even though lower rates are applicable to special cases, in this thesis, the standard 25% tax rate will be used. China uses a residence-based tax system, which means that China wants to tax the local income and the world income of its residents and resident enterprises. Hong Kong, on the other hand, uses a so-called territorial tax system, which means that Hong Kong only tax assessable income derived from Hong Kong (local income).[25] Because of the territorial tax system, world income of a Hong Kong enterprise is not taxed in Hong Kong. The next table presents an overview of the corporate tax rates:

	China corporate tax rate	Hong Kong corporate tax rate
Local income	25%	8.25% (up to 2 million) - 16.5% (for profits over 2 million)[26]
World income	25%	0%

Table 1. A short overview of the differences between China and Hong Kong income tax.

In principle, business profits can be double taxed. For instance, if a Chinese resident enterprise derives income from country B, China taxes the world income of the enterprise, but country B may also tax the profits of the enterprise because its income is sourced from B. If a DTA is

[24] (EITL) 中华人民共和国企业所得税法 Zhōnghuá rénmín gònghéguó qǐyè suǒdéshuì fǎ. [Enterprise Income Tax Law of the People’s Republic of China] (2008), article 4; (EITR) 中华人民共和国企业所得税法实施条例. Zhōnghuá rénmín gònghéguó qǐyè suǒdéshuì fǎ shíshī tiáolì. [Regulations of the People’s Republic of China on the Implementation of the Enterprise Income Tax Law] (2007), article 3.
[25] Profits tax of Hong Kong (n.d.), part 4, section 14-1; Inland Revenue Department (2009), p. 1
[26] Profits tax of Hong Kong (n.d.), Schedule 8B-2-a-i & ii

applicable, then article 7 stipulates which side may tax the profits and which side should give a tax credit/exemption. Article 7 of a DTA is a general article that comprehends all business profits, except business profits that are attributable to a special article such as article 6 and 5 of the DTA. Article 7 stipulates that profits are taxed by the country where the permanent establishment (PE) is based.[27] (more details about the PE will be given later, but in short a PE is a place of business through which the business of an enterprise is carried on in the other country) In this way, due to the applicability of a DTA, the income of the enterprise is not double taxed.

If the profits are attributable to a PE in one country, then the other country is not supposed to tax it. Generally speaking, profits are calculated by using the domestic laws of the country where the PE is established.[28] In addition, there are, however, two different approaches to calculate the profits of a PE. The UN version of the DTA adopts the principle that not all expenses are deductible, such as some payments made between the head office and its other offices.[29] The UN also uses a limited principle of force of attraction. This means that certain types of transactions are automatically attributed to the PE.[30] The OECD version of the DTA does not use a limited principle of force of attraction. It does contain a rule that stipulates that each source of profit should be subjected to a PE test.[31]

Because the profits of a PE are calculated using the domestic laws of a third country, there will generally be no difference in profits in the third country, regardless of whether the PE in question is Chinese owned or Hong Kong owned.[32] The only thing that can make a difference is if a DTA article is based on the OECD or the UN version. To what extent can differences between a Chinese or Hong Kong DTA occur? For instance, the DTA between Belgium and Hong Kong uses the UN version, while the China – Belgium DTA uses the OECD version. As a consequence, a Chinese PE can deduct more from their profits than if the same PE were owned by a Hong Kong enterprise. The difference between the DTAs can be regarded as a tax benefit. In the next table the differences between the DTAs are shown.

[27] OECD commentary (2017), p. 173; United Nations (2018), p. 216; OECD model convention (2017), article 7 paragraph 1
[28] OECD commentary (2017), p. 182
[29] United Nations (2018), p. 16
[30] United Nations (2018), p. 15-16, 218
[31] OECD commentary (2017), p. 176
[32] The attributable profits to the Hong Kong or Chinese owner can be changed if different accounting principle are used than in the third country. Due to time and space constraints, I will not go further into the differences between the accounting principles in Hong Kong and China.

	Sets with identical articles	Sets that contain articles that are based on the same version but are nonetheless different	Sets where each article is based on a different version
36 sets of DTAs	21	8	7

Table 2. How apparent are differences between DTAs? Are there big differences between the treaty between China and a third country and that between Hong Kong and the same third country? If the sets of DTAs are identical, then there is no difference between the DTA signed with the third country and Hong Kong/China. If the sets contain articles that are based on the same version, it is still possible that differences, therefore tax benefits, exist. If the articles are based on entirely different versions, then one way or another tax benefits arise.

The impact of the differences between this article is small because more than 80% of the sets are identical or basically the same. In more than 80% of the DTAs, the locally attributed profits are the same as for the third country. When it comes to the deduction of costs of a PE, the tax benefits are not common. Only 19% of the sets contain a potential tax benefit as mentioned for the Belgium DTA.

2.2. Income from immovable property

Now that the risks of certain tax benefits from general business profits are determined, there is a special kind of business profits, the so-called income from immovable property. The double taxation on income from immovable property[33] is managed by article 6 of the DTAs. Income from immovable property is a bit different from the general business profits. With the income from immovable property, the country where the immovable property is situated, may tax the profits of that property, even if the profits belongs to a PE.[34] Because the source state may always tax the profits first based on its domestic rules, the DTAs will not play an important role in this case. On the other hand, the interaction between the domestic rules and the tax system of Hong Kong or China plays an important role in this case. For instance: if a country does not levy taxes on agricultural income that is domestically sourced, as is the case in Pakistan, it does

[33] OECD commentary (2017), p. 171: The term immovable property also includes forestry or agriculture, the sale of agricultural or forestry products, and the trade and or acquisition of emissions permits connected to the agriculture or forestry
[34] OECD commentary (2017), p. 171; United Nations (2018), p. 211-212

matter if a Hong Kong or a Chinese enterprise owns the PE.[35] Income from agriculture located in Pakistan, owned by a Chinese resident enterprise, will not be taxed in Pakistan based on the domestic rules. Because the profits are not taxed, China taxes it based on the world income of the Chinese resident enterprise.[36] If the PE is owned by a Hong Kong enterprise, it will also not be taxed because of the Pakistan domestic rules. But the income will also not be taxed by Hong Kong because of their territorial tax system. This way, a Hong Kong subsidiary can receive a tax benefit because it does not need to pay tax at all.

2.3. Permanent Establishment

As mentioned in the beginning of this chapter, business profits are only taxable in the country where the PE is established. A PE is used in international taxation to make it clear where income or profits are derived from, and which country may levy tax.[37] That is also the reason why article 5 of the DTAs contain definitions of a PE.

Based on the introduction of article 5, a permanent establishment is defined as: 'a fixed place of business through which the business of an enterprise is wholly or partly carried on.' A place of business can be defined as a facility such as premises or, in certain instances, machinery and equipment. The definition of 'fixed' means that it must have some form of permanence.[38] Examples of a permanent establishment are: a place of management, a branch, and any place of extraction of natural resources.[39]

2.3.1. Special PEs

A special kind of PE is the construction PE. This kind of PE are building or construction sites, assembly or installation projects, or supervisory activities in connection to such activities. Construction PEs typically contain a time threshold. If the project takes longer than the time threshold stipulates, it is regarded as a PE (but only if all the other PE requirements are met) and therefore taxable in the situated country. The OECD model of the DTA assumes a threshold of 12 months, while the UN model uses only 6 months.[40] However, countries are free to negotiate their own thresholds in the respective DTAs.

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[35] Ahmed, Na Li, & Mellor (2018), p. 477, 'This is the situation given on august 2018' Agricultural income is essentially exempt in Pakistan.
[36] EITL, article 3.
[37] OECD commentary (2017), p. 31
[38] OECD commentary (2017), p. 117
[39] OECD commentary (2017), p. 31
[40] OECD commentary (2017), p. 31

Another type of PE that uses a time threshold is the so-called Service PE. A service PE comes into existence if an enterprise provides services to a project for a longer period than the time threshold. For instance, if a Hong Kong company provides services in Belarus for longer than the time threshold in the DTA, a PE will exist. The profits of the services can then be taxed in Belarus.[41]

In short, if profits are not attributable to a PE in a third country, it will be taxed in the other country. If a Hong Kong enterprise carries on building activities in country Z for 3 months, while the threshold for a construction PE is 6 months, then the profits will not be taxed in country Z. The profits are also not taxed in Hong Kong. If a Chinese enterprise carries on building activities in country Z for 3 months, while the threshold is also not met, then the profits are not taxed in country Z. In this case China taxes the profits based on the world income. However, if the threshold of a PE is met, then the profits will be taxed in the third country, and there will no longer be a difference for Hong Kong or China. To see whether it is profitable to have a Hong Kong subsidiary or not, it is important to look at the length of a time threshold. In the next table the time thresholds for the PEs are shown.

36 DTA pairs	Construction PE threshold	Service PE threshold
Neutral	15	22
Beneficial for Hong Kong	4	8
Beneficial for China	17	6

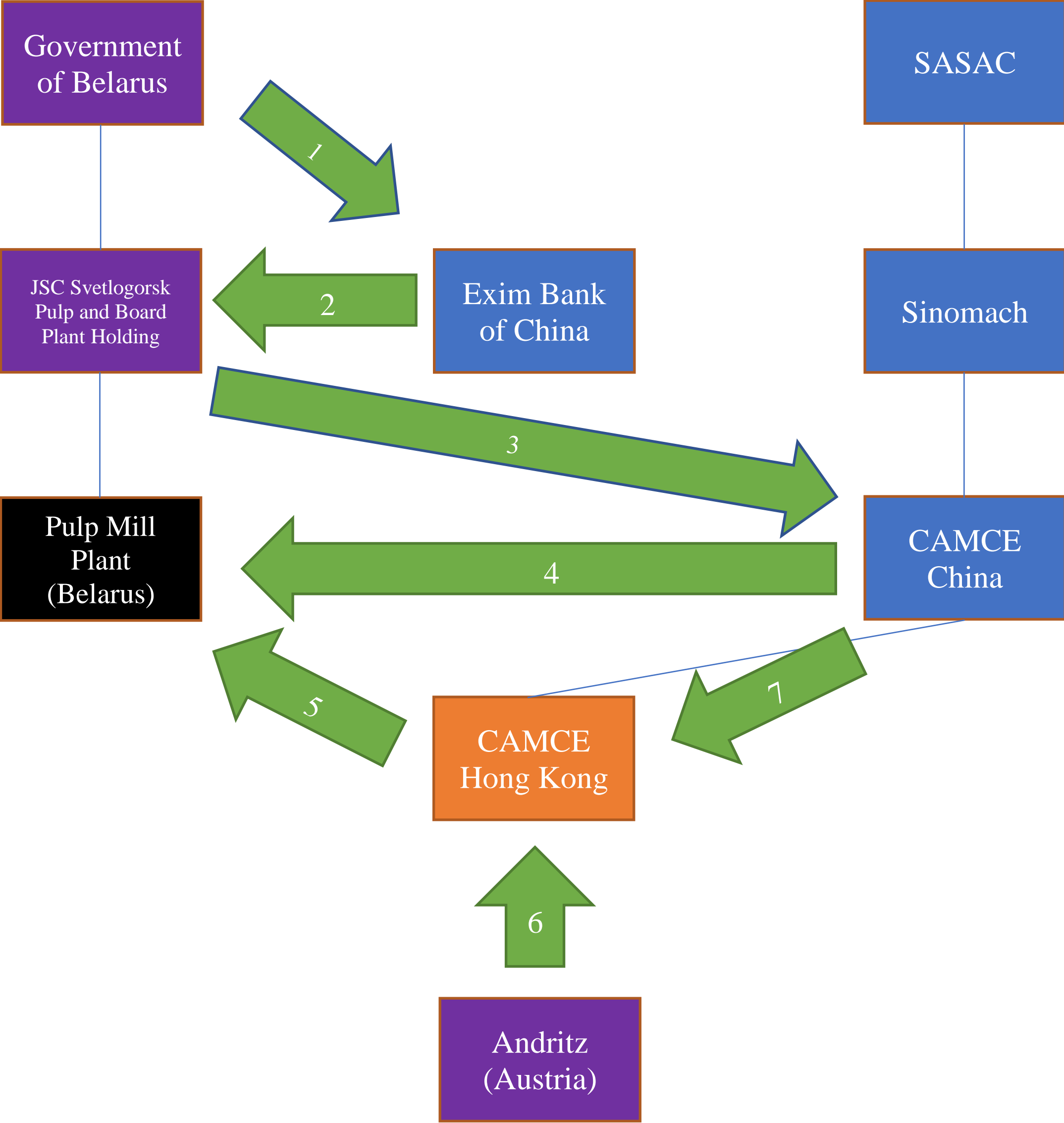
Table 3. Time thresholds for PEs. Neutral means that there is no difference in the time threshold between a Chinese owned PE or a Hong Kong owned PE in the same third country. A time threshold is more beneficial for a Hong Kong subsidiary if the time threshold for Hong Kong is longer than the time threshold in the DTA that China signed with the same country. For China it is the other way around.

Based on the data from the table, we see that the time threshold stipulations are beneficial to China more often than that they are beneficial to Hong Kong. However, ownership of a Hong Kong subsidiary can still lead to tax benefits, as we see in the numerous construction projects carried out by Chinese SOEs under the BRI. In the next case it is shown how using a Hong

[41] Belarus – Hong Kong Income Tax Agreement (2017), article 5-3-b,

Kong subsidiary contributes to an overall lower tax burden in a construction project carried out by a Chinese SOE.

THE SVETLOGORSK CASE



This case is about the construction of a pulp mill plant in Belarus. As can be deduced from several sources, the Government of Belarus guarantees a loan (1) from the Exim bank of China (2) to the Belarussian consortium 'JSC Svetlogorsk' that orders (3) the Chinese SOE China CAMC Engineering (CAMCE China) to build the pulp mill plant (4).[42] CAMCE China is a

[42] The PowerPoint, JSC 'Svetlogorsk pulp & board plant (2014), slide 4. It is not known who or what commissioned this PowerPoint. By cross referencing other sources, I believe that the PowerPoint comes from the presidential press service, because the source: Oktiabrskiy

Chinese resident enterprise, and therefore has access to the Belarus - China DTA. The profits of the construction project are taxable in Belarus if the project takes longer than the 18-month time threshold stipulated in the DTA.[43] Because the project did take longer than the 18 months the project is a PE for the DTA and CAMCE China was liable to profits tax on this project in Belarus.[44]

Note, however, that the construction was not carried out by CAMCE China alone. The machines were bought (7) at the Austrian firm Andritz (6) and installed (5) by China CAMC Engineering Hongkong co. ltd. (CAMCE Hong Kong).[45] This company is a resident enterprise of Hong Kong and a direct subsidiary of CAMCE China.[46] The installment by CAMCE Hong Kong can be defined as contract splitting.

Contract splitting is the technique to split up a big project into smaller projects so that each smaller part will not pass the time threshold to be a construction PE. In this case, it seems that the installation of the machines by a Hong Kong firm was separated from the construction of the factory by CAMCE China. Because CAMCE Hong Kong installed the machines, the Belarus – Hong Kong DTA is applicable on this project. While the threshold of this DTA is shorter (12 months) than the threshold from the Belarus – China DTA (18 months)[47] it seems plausible, that the installment can be done under the 12 months threshold.[48] In this way, the profits from this installation project carried out by the Hong Kong subsidiary are not a construction PE and therefore not taxed in Belarus — and not taxed in Hong Kong either, as we have seen.[49] The next table uses fictitious profits in order to show how CAMCE Hong Kong was used possibly to lower the total tax burden.

Regional Executive Committee (2012-09-03) mentions that the PowerPoint is from the presidential press service and quotes the same typo from the PowerPoint. The source quotes a presidential decree no. 391 of 30-8-2012, while only a decree with the same date and topic no. 392 exist.

[43] Belarus – China Income tax agreement (1995), article 4.

[44] Oktiabrskiy Regional Executive Committee (2012-09-03): On 3-9-12 a decision was made to clear the grounds where the factory would be built, and it was planned that the factory would be running in the 4th quarter of 2015. (PowerPoint slide 1). The website of China CAMC Engineering (China CAMC Engineering (2017)) states that on 10-12-2017 the factory started its operation.

[45] Andritz (2012), p. 42

[46] China CAMC Engineering (n.d.): China CAMC Engineering Hongkong .co.ltd is a subsidiary of China CAMC Engineering.

[47] Belarus – Hong Kong DTA, article 4.

[48] Yueyang Paper Company (2004): Andritz also manufactured, installed and tested a somewhat similar paper mill plant at the Chinese Yueyang paper factory. Andritz received the order in April 2008 and in July 2009 the machine was operational. Given the fact that in the 16 months' timeframe the manufacturing and testing also took place, it seems plausible that the installation of the machine could be done under 12 months.

[49] Inland Revenue Department (2009), p. 8: the absence of a permanent establishment does not mean that the profits are deemed to be derived from Hong Kong.

	If CAMCE China built the whole project by itself.		If CAMCE China built the project and subcontracted the installation of the machines to CAMCE Hong Kong.
Installing the machines: profits 50	Profits: 50 (Attributable to a PE)		Installed by CAMCE Hong Kong. Profits: 50 (Not attributable to a PE)
Building the factory: profits 100	Profits: 100 (Attributable to a PE)		Carried out by CAMCE China. Profits: 100 (Attributable to a PE)
Total taxable amount in Belarus:	150		100

Table 4. By using a Hong Kong subcontractor, the total taxable amount attributable to a PE can be lowered. As mentioned before, if the Hong Kong project does not reach the time threshold, then the profits will not be taxed in Belarus or Hong Kong.

It is possible to battle contract splitting. This can be done by implementing national legislative or judicial GAARs. In the future, this will also be made possible by using a Multilateral Instrument (MLI). The MLI can be regarded as extra instructions to an existing DTA that tries to implement certain anti-avoidance rules in existing DTAs, such as treaty abuse, improve dispute resolution, abuse with PEs, et cetera. China signed the MLI and also submitted the MLI for Hong Kong, but the MLIs has not been ratified by China or Hong Kong. Therefore, it is not applicable to Chinese and Hong Kong treaties.[50] The OECD commentary also states that article 29.9 (which is an anti-avoidance rule) of the model tax treaty can prevent contract splitting.[51] Article 29.9 is not included in the DTA between Belarus, China and Hong Kong, also no judicial or legislative GAARs exist in Belarussian law to combat subcontracting.

Aside from the contract splitting, more income can also be allocated out of the reach of a PE in other ways. Under certain circumstances, it is possible that services (such as management services) provided by a member of a group company to another member of the same group do not belong to a PE. This only applies, however, when the provided services are not carried out

[50] OECD Signatories and Parties (2019-11-26), p. 1-2; Hong Kong Special Administrative Region of the People's Republic of China (Submitted by the People's Republic of China) (n.d.), p. 1; OECD MLI FAQs (2017), Question 15
[51] OECD commentary (2017), p. 129

through the premises of the company that receives the services, and also the giving company should use its own personnel.[52] For instance, if a Chinese firm in Belarus purchases services from a Hong Kong company, then the services provided are not a PE for the Hong Kong company. Even if the services were provided to a project that qualified as a PE, it is only a PE for that company.[53]

2.4. Concluding remarks

What we have seen in this chapter, is that business profits gained from PEs owned by Hong Kong subsidiaries have tax benefits over their Chinese counterparts. Tax benefits based on the differences between the deduction of expenses are minimal. But tax benefits gained from PEs can be big. It is possible for a Hong Kong subsidiary to receive the business profits from immovable properties entirely untaxed. In regard to the time thresholds of service and construction PEs, it is interesting to see that the thresholds are more beneficial for China. But as we can see in the Svetlogorsk case, is that Hong Kong subsidiaries still can be used and are used for tax benefits on business profits in construction and service PEs. By subcontracting, business profits can be diverted from the local or Chinese tax, to Hong Kong's non-taxation. Even if Hong Kong is not more beneficial than China, based on the DTAs, Hong Kong's tax system can still be used for tax benefits.

[52] OECD commentary (2017), p. 150-151
[53] OECD commentary (2017), p. 150

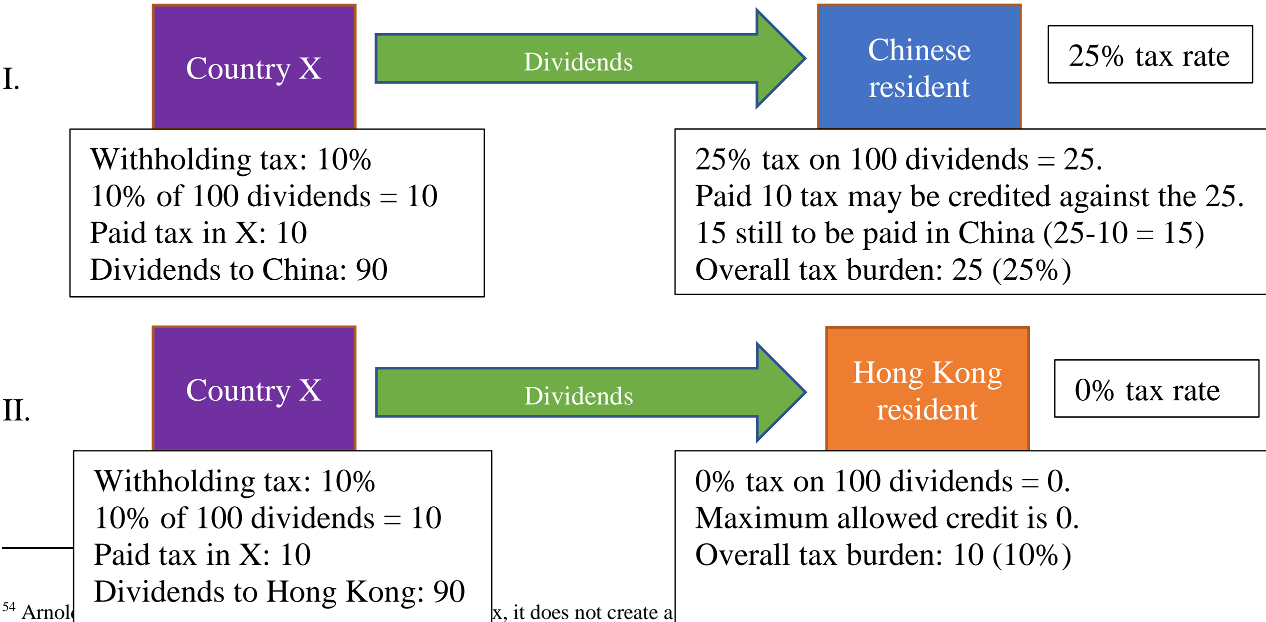
Chapter 3. Investment income

In this chapter I will focus on three types of return on investments. The first type that will be treated is the received dividends by shareholders (section 3.1). The second type is the interest earned on loans, to be discussed in section 3.2. The last type to be investigated, in section 3.3, is formed by the capital gains, such as the profits from the alienation of shares or immovable property. Section 3.4 briefly touches upon the cases in which no DTA applies and section 3.5 presents the conclusions.

3.1. Dividends

3.1.1. General rules and regulations

Dividends are the payments received by the shareholder of an enterprise. Most of the times the paid dividends are taxed in the source country with a withholding tax. If a DTA is applicable, art 10 of a DTA will stipulate what the withholding tax may be.[54] In many cases the received dividends are then also taxed by the country where the receiver is a resident of. This double taxation (the withholding tax, and later the income tax of the country where the receiver is a resident of) is managed by a DTA. There are basically three ways to eliminate double taxation: the DTA states whether the paid withholding tax may be credited, exempted or deducted.[55] The next example will show how the credit method works by using a dividend payment from country X to a resident of Hong Kong or resident of China:



[54] Arnol[...] x, it does not create a withholding tax on dividends. If the DTA states that a withholding tax is 5%, in practice the withholding tax will be 0%.

[55] Arnold (2016), p. 47, 64. The exemption and deduction method will not be treated here, because these methods are not used in the examined DTAs for profits received by residents of China or Hong Kong.

I. 100 dividends from country X are received by a Chinese resident. Country X has a withholding tax of 10% on the paid dividends. The Chinese resident receives 90. The DTA between China and X states that the paid withholding tax in X may be credited against the imposed Chinese tax. The Chinese tax on the received dividends is 25%. The Chinese tax is calculated using 100. The total tax to be paid in China is 25. The already paid withholding tax in X is 10, this may be credited against the Chinese tax of 25. Therefore, only 25 - 10 = 15 has to be paid in China. The overall tax burden for the Chinese recipient is 25%.

II. 100 dividends from country X are received by a Hong Kong resident. Country X has a withholding tax of 10% on paid dividends. The Hong Kong resident receives 90. According to the DTA the paid withholding tax may be credited against a Hong Kong imposed tax. In this case the Hong Kong tax is 0 (no tax on world income) and the 10 withholding tax cannot be credited from the 0 Hong Kong tax.[56] The total received dividends in Hong Kong is 90. The total tax burden is 10 (10%.)

All the examined DTAs use the credit method when it comes to income (dividends, interest and royalties) received by Hong Kong / Chinese resident. From the given examples, it should be clear that Hong Kong is a more beneficial place to receive dividends.[57] In the next table it is shown that Hong Kong is always a more beneficial place than China to receive dividends from third countries in regard to the DTAs and the income tax rates of China and Hong Kong.

36 sets of DTAs	Sets of DTAs more beneficial for Hong Kong recipients	No difference between Hong Kong or China	Sets of DTAs more beneficial for Chinese recipients
Dividends from third countries	36	0	0

Table 5. More DTAs are beneficial for recipients in Hong Kong then for those in China. This makes Hong Kong a more attractive place to manage your holdings from and for receiving the dividends from those holdings. Foreign dividends paid to a Hong Kong resident will generally come across lower withholding taxes in those third countries,

[56] All the examined Chinese or Hong Kong DTA states in a way that: ‘the amount of the credit shall not exceed the amount of the Hong Kong / Chinese tax on that income.’

[57] China can only be more beneficial than Hong Kong if the withholding tax in X for Hong Kong is higher than the Chinese tax rate of 25%. With the examined DTAs, that is not the case.

in comparison to dividend payments to a Chinese resident. One note on the rates: I assume that the rates are applicable on the received dividends.

The figures in table 5 clearly show that Hong Kong is a more beneficial place than China when it comes to receiving dividends based on the DTAs and income tax rates. But how easy is it to receive the dividends in Hong Kong or China? Can everyone just set up an enterprise in China/Hong Kong and use their DTAs? The next part will be about the requirements to gain access to the DTAs and the beneficial rates for dividends.

3.1.2. Beneficial Owner and Safe Harbor rule

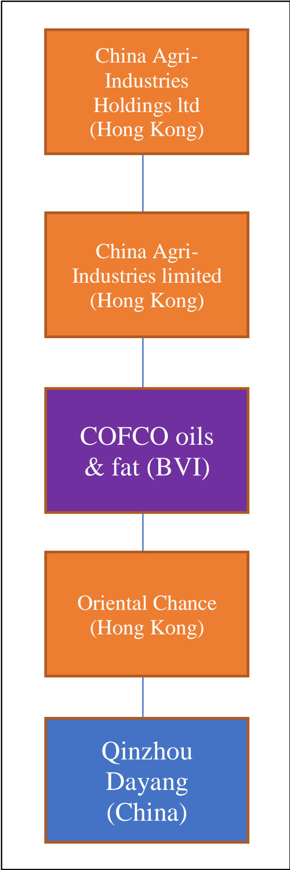
A very important element of article 10 of a DTA is the definition of 'Beneficial Owner' (BO) of the dividends. Being the BO is important, because the DTA rate is only applicable if the receiver is the BO of the dividends. In defining the term BO, Hong Kong follows the definition of the OECD:[58] 'the BO of the dividends has the right to use and enjoy the dividend, unconstrained by a contractual or legal obligation to pass on the payment.'[59] If a Hong Kong resident enterprise wants to be regarded as a BO for DTAs signed with Hong Kong, the enterprise should apply for a Certificate of Residence.[60] The Hong Kong Inland Revenue Department also notes that other factors for the application may be taken into consideration, such as that the place of management should be in Hong Kong and it should have sufficient business substance.[61] It explicitly states that a person simply acting as a shell company for another person is not a BO.[62]

The Chinese definition of a BO is defined in gonggao (Announcement) 2018/9.[63] The rules provided here define the beneficial ownership not only for dividends, but also for interest and royalties. The Announcement mentions that an extensive analysis will be carried out before an enterprise can acquire the status of a BO, and some factors will be 'unfavorable' to proving the status.[64] Factors such as: having insufficient substantive business activities, 50% of the profits going to a third country within 12 months, and the other country does not tax the income or does not have a substantial tax. Based on these requirements is should be noted that it could be

[58] Hong Kong institute of Certified Public Accountants (2018), p. 19
[59] OECD commentary (2017), p. 235
[60] Inland Revenue Department (2019), p. 59
[61] KPMG, (2017)
[62] Hong Kong institute of Certified Public Accountants (2018), p. 19
[63] 公告 2018/9. Gōnggào 2018/9. [announcement 2018/9] (2018)
[64] 公告 2018/9. Gōnggào 2018/9. [announcement 2018/9] (2018), article 2.

easier to be a BO in regard to the Hong Kong requirements than to be a BO in regard to the Chinese definition. The definition of the BO can be extended with a so-called Safe Harbor rule.

Both countries have a Safe Harbor rule but Hong Kong's rule only applies to certain special investments scheme, which I will not give attention.[65] China's Safe Harbor rule makes it possible for enterprises that are not regarded as a BO, to still regard them as a BO for Chinese dividends.[66] Basically the rule makes it possible to be a BO if another enterprise in the group is a BO. The next example will show how it generally works: Qinzhou Dayang pays dividend to Oriental Chance which is not a BO. Oriental Chance can still be qualified as the BO of the dividends if China Agri-Industries Holdings[67] is qualified as a BO. This is because the enterprise that (in)directly owns the enterprise that receives the dividends, is regarded as the receiver of the dividends.[68]



This rule can make it easier to receive Chinese dividends as a foreign (Hong Kong) shareholder, but when it comes to the total tax burden, it is not beneficial for a Hong Kong shareholder to receive the dividends when compared to a Chinese shareholder. Dividends paid between a Chinese resident enterprise and the Chinese resident shareholder are free from tax,[69] while dividends paid to a Hong Kong shareholder that is regarded as a BO is taxed in China against a DTA withholding tax rate of 5%.[70] This rule only makes it easier to pay dividends to foreign (Hong Kong) shareholders, but will have no direct effects on the taxation of those dividends.

Another reason for Chinese SOEs to pay Chinese sourced dividends to Hong Kong is the fact that Hong Kong does not have withholding tax on outgoing dividends, while China has one. It could be cheaper to pay non-Chinese shareholders (for instance: shareholders in the British

[65] Inland Revenue Department (2019-12-08); Financial Services and the Treasury Bureau (2019-03-14)
[66] 公告 2018/9. Gōnggào 2018/9. [announcement 2018/9] (2018)
[67] Yahoo finance (n.d.). China Agri-Industries is listed at the Hong Kong stock exchange, it seems plausible that it qualifies as a BO.
[68] 公告 2018/9. Gōnggào 2018/9. [announcement 2018/9] (2018), article 3. China Agri-Industries Holdings limited announcement (2018), p. 7: The corporate structure is based on the real structure, but the dividend payments are fictitious and beneficial ownerships are fictitious, although it seems possible.
[69] EITL, article 26
[70] China – Hong Kong Income tax agreement (2006), article 10

Virgin Islands) from Hong Kong instead of China.[71] Therefore, it should not be strange that much capital ends up in Hong Kong (where it also cannot be taxed by China under normal circumstances). In order to combat the accumulation of profits in a Hong Kong enterprise, China implemented a domestic GAAR,[72] called: The Controlled Foreign Companies rule (CFC rule). This GAAR makes it possible to tax profits that are indirectly owned by a Chinese resident enterprise but are not attributable to China. The next question that I would like to answer is: Is the CFC rule effective to tax profits stashed in a Hong Kong subsidiary owned by a Chinese SOE?

3.1.3. The Controlled Foreign Companies (CFC) rule

With the CFC rule, China can tax capital in foreign enterprises that are owned by Chinese resident enterprises. If a Chinese resident enterprise receives profits, it will be taxed at a rate of 25%. If a Chinese resident enterprise would, for example, use a Hong Kong resident subsidiary to receive the overseas profits, the profits will not be taxed in Hong Kong. However, if the conditions of the CFC rule are met, it is possible to attribute the profits paid to the Hong Kong subsidiary to the Chinese resident enterprise, and then tax it, effectively neutralizing the effects of this Hong Kong detour. To be regarded as a CFC, several requirements must be fulfilled. For instance, the foreign enterprise must be controlled by a Chinese resident enterprise,[73] and the effective tax rate in the country where the CFC is situated must be lower than the Chinese tax rate of 25%.[74] The CFC must furthermore own profits that are (partially) undistributed. (If there are ‘reasonable business needs’ as a result of which the profits are not distributed, then the undistributed profits can be justified.[75] The term ‘reasonable business needs’ is not defined in the relevant official documents[76] but Chinese CFC tax cases are defining the term.) The next example is the first CFC case in China, the so-called Shandong case; it gives an idea how the CFC rule works and how troublesome the definition of ‘reasonable business needs’ can be.

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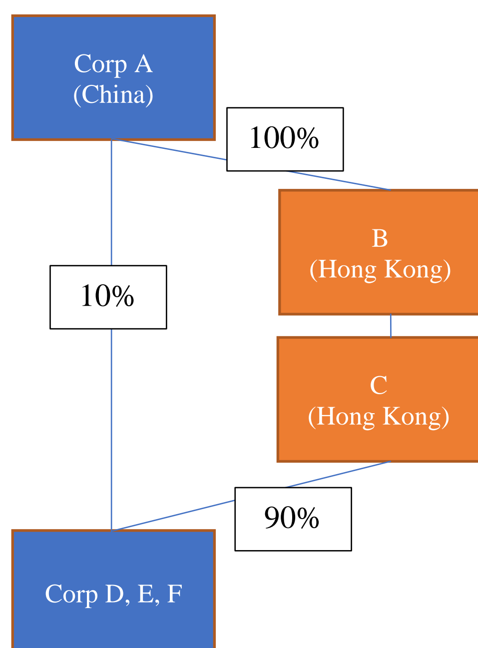
[71] Many Chinese SOEs are listed on the Hong Kong Stock Exchange
[72] The CFC rule is anchored in article 45 EITL, article 116-118 EITR and more specifically defined by specific official documents: 财税 2009/2. Cáishuì 2009/2. [Circular 2009/2] (2009); 国税函 2009/37. Guóshuì hán 2009/37. [State tax letters 2009/37] (2009).
[73] EITR, article 116: This can also be an individual. In a multilayer structure, the shares per layer should be multiplied by the percentage of control. If a percentage is above 50%, the whole subsidiary is regarded to be 100% owned by the parent company. 财税 2009/2. Cáishuì 2009/2. [Circular 2009/2] (2009), article 77; 国税函 2009/37. Guóshuì hán 2009/37. [State tax letters 2009/37] (2009). There is a list of certain white-listed countries. If the enterprise is in one of those countries, it is exempted for the CFC rules. Hong Kong is not on that list.
[74] EITR article 118: states that the effective tax rate is 50% of the 25% tax rate of article 4 EITL.
[75] EITL article 45: ‘合理的经营需要’ (Hélǐ de jīngyíng xūyào] is translated as ‘reasonable business needs’. 财税 2009/2. Cáishuì 2009/2. [Circular 2009/2] (2009), article 84 mentions ‘主要取得积极经营活动所得’ (Zhǔyào qǔdé jījí jīngyíng huódòng suǒdé) this roughly translates to: reasonable business activities.
[76] Cui Xiaojing & Zhang Han (2018)

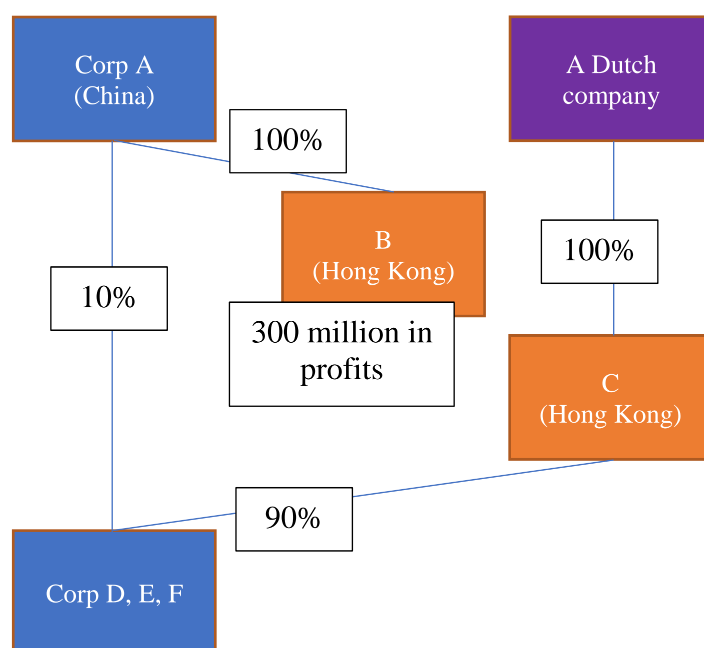
THE SHANDONG CASE

In this example, the CFC rule is applied on a Chinese enterprise that owns a Hong Kong subsidiary with undistributed profits. The Hong Kong subsidiary (B) (see the scheme below) earned the profits by selling the shares in C to a Dutch company (the transaction). The profits from this deal were 300 million Renminbi that remained in B. After the sale, B tried to be registered as a Chinese tax resident so that it could pay the 300 million Renminbi tax free[77] to another Chinese tax resident. The tax residency of B was denied, and the Shandong Province Revenue Service investigated this deal. In 2014 the Shandong tax office concluded that B qualified as a CFC and therefore the profits of 300 million Renminbi must be attributed to the owner of B, Corp A.[78]

Before the transaction



After the transaction



The reason why B was qualified as a CFC was because the Shandong tax office judged that B's income from dividends, royalties, interest and capital gains, are deemed as negative income that are not regarded as 'real' business activities.[79] B did have legitimate other business activities, but the main income was negative income.[80] In another CFC case, the so-called Suzhou case,

[77] EITL, article 26
[78]北京国税二直属. Běijīng guóshuì èr zhíshǔ. [Directly under Beijing National Taxation] (2017)
[79] 中国税务报. Zhōngguó shuìwù bào. [China Tax News] (2017)
[80]华税. Huá shuì. [China tax] (2017)

the Suzhou tax office ruled that a Hong Kong subsidiary that accumulated profits qualified as a CFC. The Hong Kong subsidiary claimed that the accumulation of profits was intended to expand the company. If that were the case, it would be a reasonable business need and no CFC rule would be applicable on the profits. But the tax office concluded that the Hong Kong company did not reinvest their profits, and it could not be exempted from this rule.[81]

The Chinese CFC could be an effective GAAR, but it seems that the vagueness of the requirements hampers its effectiveness. In the Shandong case it was ruled that certain income was negative income and therefore not regarded a reasonable business needs. In the Suzhou case it is said that if accumulated profits are intended for reinvestment, the CFC rule does not apply. Does this mean that to reinvest negative income can be regarded as a reasonable business need? Also, if a Chinese enterprise transferred enough activities so as to be regarded as a reasonable business need to the Hong Kong subsidiary, the CFC rule cannot be used. It seems likely that the CFC rule is not effective enough to make a Hong Kong subsidiary an unattractive alternative. However, its ineffectiveness connects well with the idea that: 'the Chinese tax office is enforcing GAARs against inbound investment but has adopted a very friendly attitude towards outbound investment.'[82] Meaning that the Chinese tax office is not focused on accumulated profits from outbound investment.

In the next case, we see the consequences of when a Hong Kong subsidiary is not regarded as a CFC. It is possible that the Hong Kong subsidiary receives profits from another country, and the Hong Kong subsidiary immediately pays dividends to its non-Chinese shareholder enterprise. The shareholder enterprise, which is a resident of the British Virgin Islands (BVI), does not have to pay taxes on the received dividends, because the BVI does not levy any income tax.

THE COGOGL CASE

The Chinese SOE CSCEC directly and indirectly owns another Chinese SOE called COGOGL.[83] The shares of COGOGL, which indirectly owns numerous holdings in China,[84]

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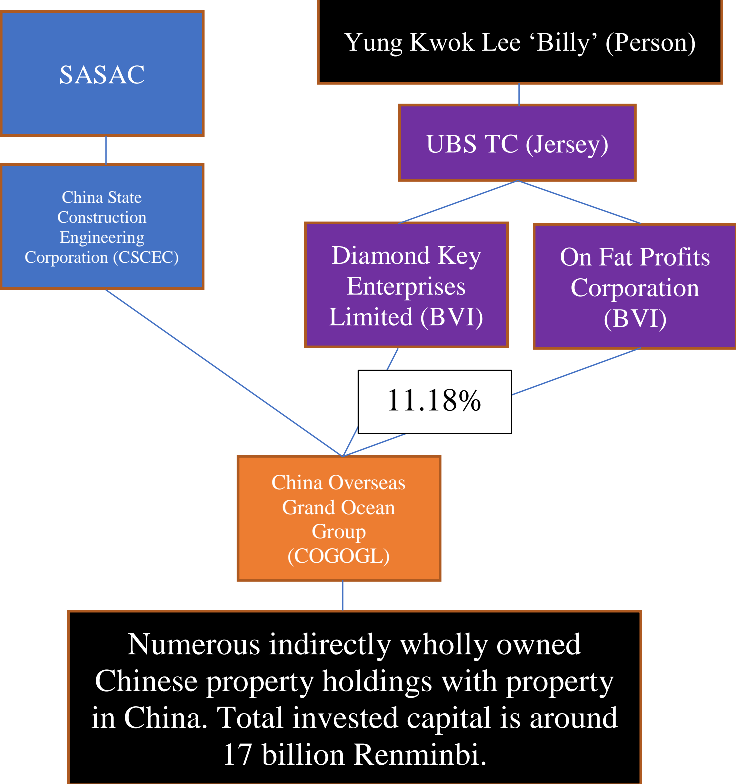
[81] 中国税务报. Zhōngguó shuìwù bào. [China Tax News] (2017)
[82] Yang Yating (2016), p. 677
[83] COGOGL, China Overseas Grand Oceans Group ltd. (2018), p. 63
[84] COGOGL (2018), p. 182-185

are for 11.18% indirectly held by UBS TC (Jersey).[85] In 2018, the expected dividend pay-out indirectly to UBS TC was 54,331,711.84 Hong Kong dollars.[86] Because there is no dividend withholding tax in Hong Kong, these dividends were not taxed.[87] By paying dividends to the BVI shareholder enterprises, the received dividends cannot be taxed by a Chinese CFC because no Chinese company has the control over the BVI shareholder enterprises. The dividends paid to the BVI enterprises are not taxed in the BVI. If the dividends where paid to a Chinese resident enterprise, the dividends would be taxed under the Chinese income tax of 25%. But if the dividends where meant to end up in China, it would not be convenient to pay dividends from Hong Kong. If the Chinese property was held by a Chinese enterprise, the paid dividend to the Chinese resident shareholder would be tax free. The Hong Kong route clearly is used to get dividends out of China, where there are more tax benefits for receiving (the DTA benefits) but also paying dividends (no withholding tax).



[85] COGOGL (2018), p. 48
[86] COGOGL (2018), p. 10
[87] There is no DTA between Hong Kong and the BVI. Because of the tax systems of these two nations, double taxation is not a serious threat.

3.1.4. Conclusion

When it comes to receiving dividends, Hong Kong is a better place than China. Not only do all the DTAs favor Hong Kong, but it is also easier to be regarded as a BO in Hong Kong than in China. It seems that China's Safe Harbor rule only widened the definition of a BO, therefore making it easier for foreign (for example, Hong Kong) shareholders to receive dividends from China. Paying dividends from Chinese and other overseas sources to Hong Kong can also be beneficial if dividends are paid to the shareholders (for instance shareholders on the BVI) of the Hong Kong enterprise, because Hong Kong has no withholding tax on dividends paid to shareholders. The use of Hong Kong as a capital storage is not effectively curbed by the Chinese CFC rule. The rule is vague, and it seems that China is not focusing on taxing the profits from overseas assets stashed in Hong Kong. As we saw in the Shandong case, it can work on profits from Chinese assets, but it could be possible that the requirements of the rule are simply fulfilled, and therefore the rule is not applicable. In short, the CFC rule makes it harder to use a Hong Kong subsidiary to accumulate wealth in, but it is not yet so successful that this practice has been eliminated.

3.2. Interest

The earlier mentioned combination of tax rates, the existence of a withholding tax rate and the credit method also applies to interest. Hong Kong does not have a withholding tax for paid interests, and China maintains a 10% withholding tax rate on paid interests. Article 11 of the DTA can stipulate a different withholding tax rate and can also stipulate which country may levy taxes and which country should give a tax credit. As shown in table 6, all the examined DTAs employ the credit method, and all the given DTA withholding rates on interest for Hong Kong are lower than the Chinese tax rate of 25%. Therefore, in all these DTAs Hong Kong is a more beneficial place than China to receive foreign interest.

36 sets of DTAs	Sets of DTAs more beneficial for Hong Kong recipients	No difference between Hong Kong or China	Sets of DTAs more beneficial for Chinese recipients

Interest from third countries	36*	0	0

Table 6. The table shows that DTAs signed between third countries and Hong Kong contain better (lower) withholding rates than DTAs signed between the same third countries and China. Hong Kong can be a better place to receive the interests from third countries. *In some cases, the interest from state banks or other governmental affiliated financial institutions is exempted from tax, such as the Hong Kong Monetary Authority, the Chinese Silk Road Fund and the Exchange Fund of Hong Kong.[88] The given numbers do not take these exemptions into account.

Based on the domestic tax rates and the DTA rates, it is more beneficial to receive interest in Hong Kong than in China. Another difference between China and Hong Kong is the fact that China uses a GAAR called the Thin Capitalization rule. For some special cases, Hong Kong does have some restrictions on interest deductions, and sometimes interest arising from offshore loans is taxable in Hong Kong, but in general no interest deductions apply on interest.[89]

The Chinese rule is codified in article 41 of the EITL and essentially prohibits certain interest deductions. By giving loans with high interest that are not in line with the at arm's length principle[90] to associated enterprises/subsidiaries, a higher interest deduction can be achieved. The Thin Capitalization rule tries to undo these effects by making only the 'real' interest deductible from the profits.[91] According to this rule, if the entity can prove that the interest *is* in line with this principle and if the effective tax rate of the borrowing entity is not higher than that of the lender's, the paid interest is still deductible.[92] The interest is also not deductible if the debt-to-equity ratio is too high (5:1 for financial institutions and 2:1 for other enterprises).[93] This ratio is important for enterprises that function as the main lender in a corporation and that tend to have a high ratio.

In contrast to the CFC rule that can reach foreign companies controlled by a Chinese entity, the Thin Capitalization rule can only impact entities that pay Chinese corporate income tax.

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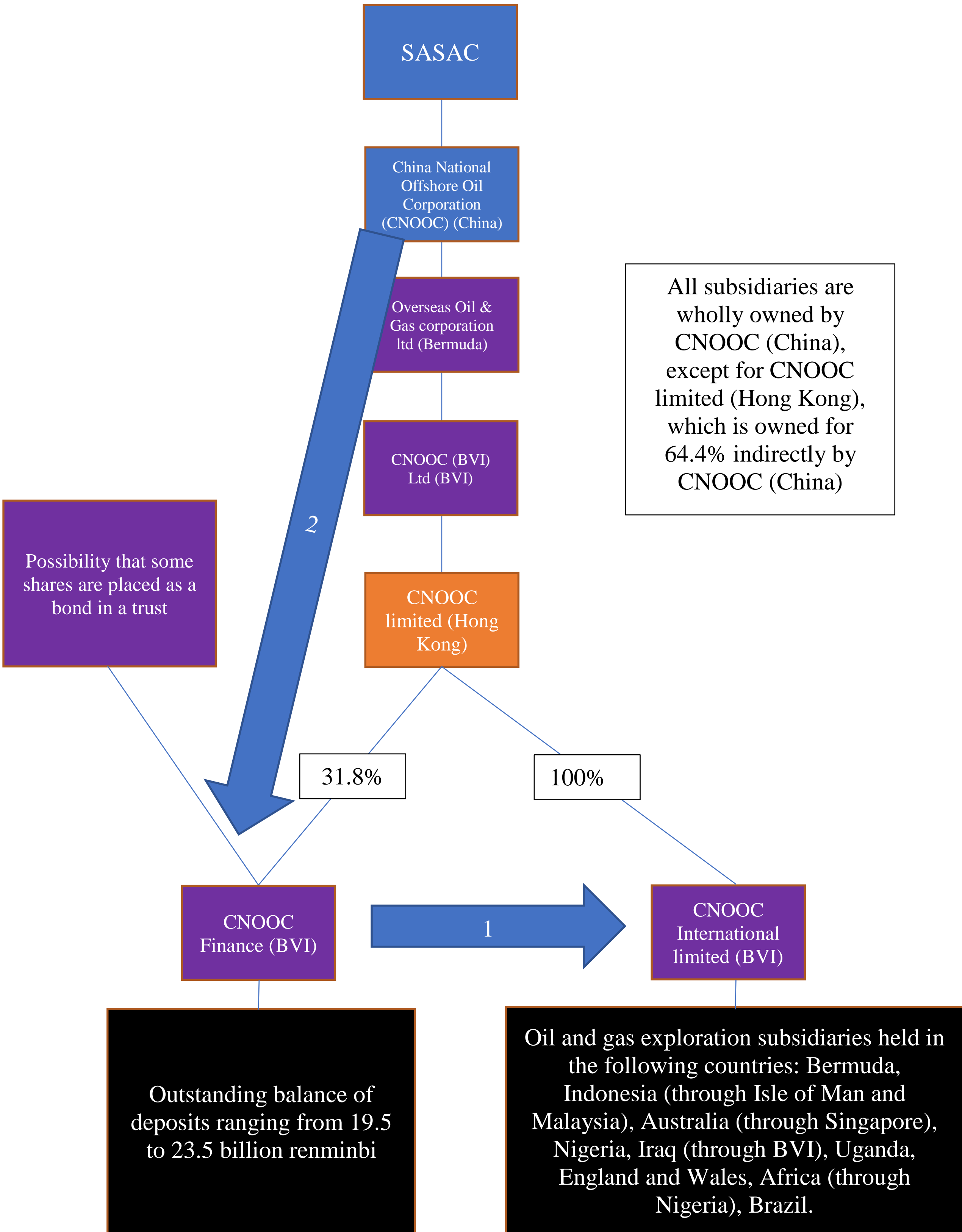
[88] Pakistan – China DTA (1989), Article 11; Belarus – Hong Kong DTA (2017), article 11.
[89] Inland Revenue Department (2004), p. 9-10; Inland Revenue Department (2009), p. 25
[90] Arnold (2016), p. 92, this principle recalculates payments (of interest but also the price of goods or services, this is also called: transfer pricing) between **associated** enterprises. The recalculation is based on the 'real' interest that would have been paid between two **non-associated** enterprises.
[91] EITR, article 123; 财税 2015/2. Cáishuì 2015/2. [Circulars 2015/2] (2015), article 36.
[92] 财税 2008/121. Cáishuì 2008/121. [Circulars 2008/121] (2008), article 2.
[93] 财税 2008/121. Cáishuì 2008/121. [Circulars 2008/121] (2008), article 1.

Therefore, the reach of this GAAR is limited to Chinese tax residents and therefore Hong Kong is a better place to establish SOE financing activities as they will be out of China's taxation reach. However, it is an interesting question why some Chinese SOEs prefer finance enterprises in tax havens such as the British Virgin Islands (BVI),[94] instead of Hong Kong. As earlier mentioned, one reason can be that Hong Kong, in certain cases, has some restrictions on interest deductions and sometimes it taxes interest from offshore loans. While the BVI, for instance, has no such limitations. The next case shows that the use of BVI finance enterprises is more profitable than a Hong Kong route would have been.

[94] The reason why I focus on the BVI is that most Chinese SOEs own one or more BVI enterprises.

THE BRITISH VIRGIN ISLANDS CASE



As can be deduced from the CNOOC annual report, and several SEC filings, in this example CNOOC Finance[95] gave CNOOC International a loan of 135 million dollars at an interest rate of 0.95% (1).[96] The earned interest in CNOOC Finance is not taxed and the paid interest is deductible from the profits in CNOOC international.[97] If both enterprises were Hong Kong resident enterprises, interest deduction restrictions could apply.

The second loan is a 600 million dollars loan from CNOOC (China) to CNOOC Finance with also an interest rate of 0.95% (2).[98] It seems that the 600-million-dollar loan from CNOOC (China) is lend to other holdings based on the BVI. It is not known to me if there are more loans between CNOOC Finance and CNOOC International, but it seems plausible that more such loans exist when regarding the fact that CNOOC Finance is a financing enterprise[99] and all non-financing activities are concentrated in CNOOC International.[100] By using the BVI instead of a Hong Kong enterprise to finance activities, no interest deduction restriction rule applies on the paid interest or any tax will be levied over the received interest.

Based on the DTAs, Hong Kong is a better place than China when it comes to receiving and paying interest, also the fact that China has a Thin Capitalization rule does not strengthen the Chinese case. But for Chinese SOEs Hong Kong is not the preferred place to finance activities from. As we can see from the last example, if CNOOC finance would be a resident of Hong Kong, several restrictions on interest deductions could be in place. Also, the received interest from loans to CNOOC international could be liable to tax in Hong Kong. The BVI has no such restrictions, therefore Hong Kong is bested by the BVI.

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[95] CNOOC Finance consist of multiple BVI enterprises, all called CNOOC Finance (YEAR). All are owned by CNOOC ltd Hong Kong.
[96] United States Securities and Exchange Commission (n.d.), p. 90
[97] Deloitte (2019), p. 1-3. The BVI has a tax of 0% on profits. There is no Thin Capitalization rule on the BVI. Interest deductions will have no effect, since profits are not taxed.
[98] United States Securities and Exchange Commission (n.d.), p. 90
[99] CNOOC China National Offshore Oil Corporation (2018), p. 57
[100] CNOOC China National Offshore Oil Corporation (2018), p. 106

3.3. Capital gains

The last type of return on investment are the capital gains derived from the alienation of shares, immovable property or shares that derive their value directly or indirectly from immovable property. The income tax rates for capital gains are the same rates as for the dividends and interests. If the capital gains are attributed to a Chinese resident enterprise the tax rate is 25%. For Hong Kong there is no tax on capital gains.

Article 13 of the DTA is concerned with the taxation of capital gains in situations where double taxation can arise. It sees on the alienation of shares, and the alienation of shares that derives more than 50% of their value from immovable property.[101] If a Chinese enterprise sells it shares in a foreign enterprise, the capital gains are taxed in the country where the alienator is a resident. In this case China will tax the capital gains at a rate of 25%. If the shares derive more than 50% of its value from immovable property, then the country where the immovable property is situated may tax the capital gains of that alienation.[102] A different rate than the 50% rate is possible.

As for the interest and dividends, only the credit method is used in the DTAs for the income of capital gains. If a foreign tax is paid over the capital gains, it may be credited from the Hong Kong or Chinese taxation. All the DTAs favor Hong Kong over China when it comes to receiving capital gains from the alienation of shares. If the capital gains from the alienation of shares that derive a certain percentage of their value from shares are attributed to China or Hong Kong, Hong Kong is in 100% of the cases a better place to receive the capital gains than China. When examining the percentage of value that a share should derive from immovable properties, we can see that in 66% of the cases Hong Kong is also a better place to manage those kinds of shares from. This means that shares held by a Hong Kong enterprise also needs a higher percentage of value derived from immovable property, therefore making it harder to meet such a percentage. The results are summarized in the next table:

[101] OECD Model Convention (2017), article 13; United Nations (2018), p. 25
[102] OECD Model Convention (2017), article 13, paragraph 4.

36 sets of DTAs	More beneficial for a Hong Kong enterprise	Neutral	More beneficial for a Chinese enterprise
Alienation of shares in third countries	36	0	0
Alienation of immovable property in third countries	36	0	0
For whom is the percentage of value derived from immovable property more beneficial? *	24	4	8

Table 7. The used rates are the lowest rates, without taking into consideration the percentage of ownership of the shares. *Solely based on the lowest percentages possible.

The DTAs heavily favor Hong Kong when it comes to capital gains. Hong Kong is objectively a more beneficial place than China to receive capital gains. As such, it is understandable why most SOEs use Hong Kong enterprises as holdings to organize their overseas assets from. Not only overseas assets are held by a Hong Kong subsidiary, in some cases Chinese SOEs also hold their Chinese assets through a Hong Kong subsidiary. (for example, in the COGOGL and Safe Harbor cases.) It could be possible that Chinese assets are owned by a Hong Kong subsidiary to avoid the Chinese tax. If a Hong Kong subsidiary will alienate the shares, it is taxed in Hong Kong, and not China. China implemented a GAAR called the Indirect-Transfer rule in order to fight this practice.

The GAAR sees on foreign entities alienating shares in a foreign entity that (in)directly holds an interest in a Chinese resident enterprise.[103] For instance, suppose a Chinese resident enterprise A is owned by B (Hong Kong resident) and B is owned by C. If B alienates the shares in the Chinese enterprise, it is possible that the capital gains can be taxed in China based on the DTA. Chinese taxation can be avoided if not B alienates the shares in A, but if C alienates the

[103] 公告 2015/7. Gōnggào 2015/7. [announcement 2015/7] (2015)

shares in B. In this way, the capital gains will be sourced in Hong Kong and no taxes are levied on the capital gains. If the conditions of the GAAR are met, the transaction must be adjusted, as if the alienation of shares in A was directly done by B.[104] In general the GAAR will not be applicable if there is a reasonable business purpose for the transaction. As with the term 'reasonable business needs' from the CFC rule, the term 'reasonable business purpose' also lacks a clear definition.[105] It is hard to say whether this GAAR is effective when it comes to alienations, but the use of Hong Kong subsidiaries to hold Chinese assets is still a widespread phenomenon. Because this rule only is effective for Chinese based alienations and no other types of alienations, I will not further examine it.

3.4. Conclusion

When it comes to income from investments such as dividends, interest and capital gains Hong Kong is the place to be. Not only do the DTA provisions favor Hong Kong 100% over China, but also the Chinese GAARs are not very effective in making Hong Kong equally attractive as China for receiving investment income. Hong Kong is more beneficial when it comes to receiving and paying dividends. The Chinese Safe Harbor rule makes it even easier to be qualified as a BO for Chinese dividends. The overall tax burden on received dividends is lower than the tax burden in China. The CFC rule should make it possible to tax accumulated wealth in Hong Kong, but the rule is not very clear in its requirements and it is suspected that the Chinese tax office is not really focusing on taxing stashed profits derived from overseas assets. The paid dividends from Hong Kong to shareholders are also not taxed with a withholding tax as we could see in the COGOGL case.

The taxation of interest follows the same path as the dividends. The DTAs favor Hong Kong, and China has a Thin Capitalization rule that makes it an unattractive place to conduct finance activities from. In comparison with China, Hong Kong is the better place to receive and pay interest from. But Hong Kong is not the best place to finance group activities from. As we could see in the British Virgin Islands case, Chinese SOEs prefer to use BVI enterprises to finance their activities. The reason for this preference could be that Hong Kong has some restrictions on interest deductions and in some cases the received interest is taxed. All of which the BVI lacks.

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[104] EITL, article 47

[105] 公告 2015/7. Gōnggào 2015/7. [announcement 2015/7] (2015); Na Li (2019), p. 64-65,

The taxation of capital gains is the same as with the interest and dividends. The DTAs again objectively favor Hong Kong over China. In regard to the taxation of capital gains, Hong Kong is such a beneficial place that even Chinese assets are held by Hong Kong subsidiaries. The Chinese Indirect-Transfer rule tries to mitigate the effects, but it is not known whether it is successful or not in curbing these practices. Considering the fact that Hong Kong is still used to own Chinese assets, it could be possible that these practices are not effectively curbed.

Objectively based on the DTAs, Hong Kong enterprises are more beneficial for tax reasons than Chinese enterprises. It is better to have a Hong Kong subsidiary own the overseas and Chinese assets. It is well known that Hong Kong functions as a financial center for investments in China.[106]

[106] Yang Yating (2016), p. 119; Vlcek (2010), p. 670

Chapter 4. Conclusions

After having surveyed the Chinese and Hong Kong tax laws, the relevant DTAs and GAARs, we can safely conclude that a Hong Kong subsidiary can have significant tax benefits (for the taxes under consideration) for Chinese SOEs. We also saw that these tax benefits are not incidental. Much of the overseas assets owned by the SOEs are managed from Hong Kong and in many cases the SOE corporate structure consist of more Hong Kong entities than Chinese entities (in some such cases, it would be better to call them Hong Kong SOEs rather than Chinese SOEs). In view of these conclusions, possible tax benefits on other types of taxation, such as transfer pricing and royalties, would be worth investigating as well.[107]

In the technical chapters 2 and 3 we have not considered ethical issues, but it is good to point out that, from a general perspective, the fact that a Hong Kong subsidiary can lead to non-taxation is not necessarily a good thing. For instance, in some cases it is possible for a Hong Kong subsidiary to earn untaxed profits from immovable property (such as agriculture) situated in a third country because the third country in question does not have a tax on agricultural products. It is not precisely known how many countries lack an effective tax on agriculture, but with the Chinese agribusiness going global under the BRI,[108] the effects of non-taxation can be severe. For instance, the Chinese SOE COFCO signed a memorandum of understanding with Ukraine and they could lease up to 3 million hectares of arable land.[109] More research focused on the taxation of farmlands in the light of the geopolitical food security should be conducted in order to explore these global effects on taxation in the source countries and other competitors in the food industry.

It is estimated that between 2005 and 2018 approximately 814 billion US dollars has been invested by China in overseas construction projects.[110] As I have shown in the Svetlogorsk case, a Hong Kong subsidiary can gain untaxed benefits from these kind of construction projects by subcontracting parts of a bigger project, thus avoiding taxes that would otherwise have been paid to the third country in which such construction projects are taking place. [111] There are legal

[107] Royalties are covered by the DTAs and regarded as investment income. China mentioned in the United Nations (2014), that transfer pricing is used by corporations to avoid taxation in China. Transfer pricing is also covered by DTAs.
[108]GRAIN (2019)
[109] Memorandum of Understanding between China and Ukraine (2013), this is roughly the total area of Belgium.
[110] OECD (2018)
[111] Also, some special attention should be given to Chinese internet companies that provide digital services abroad. It could be possible that the provided services abroad do not constitute a PE, if the services are provided by a Hong Kong subsidiary, the profits from those services will not be taxed.

instruments based in the DTAs, MLIs or domestic tax systems to combat this practice, but not all developing countries have the right kinds of instruments to do so. There is no overview on which country has what type of legal instruments to combat this practice. More research on subcontracting and overseas construction projects is necessary, also from the perspective of tax and tax evasion. Also, the future participation in the MLI project of China and Hong Kong should be given more attention. As earlier mentioned, China also submitted the MLI for Hong Kong. Does this mean that Hong Kong has given a part of its tax independence away?

The difference between the Chinese and Hong Kong tax rates on dividends, interest and capital gains is big. As Hong Kong does not have a tax for these three types of income, this automatically makes Hong Kong the more beneficial place to receive these incomes. It is clear that Chinese SOEs are aware of these benefits as they often use Hong Kong subsidiaries not only to manage their overseas assets but also their Chinese assets! Hong Kong subsidiaries are used as intermediary enterprises between the Chinese SOE shareholder and the overseas/Chinese assets, possibly because capital gains, dividend income and interest income are not taxed in Hong Kong. Also, as we could see in the COGOGL case, the payments of dividends to shareholders of a Hong Kong enterprise are not subjected to a Hong Kong withholding tax. In addition, the Chinese Safe Harbor rule makes it easier to give more entities the BO status, on the basis of which beneficial DTA rates on capital gains, dividends and interest income derived from China can be applied for.

Chinese authorities have tried to tackle the accumulation of capital in Hong Kong by the implementation of the CFC GAAR, which makes it possible to tax undistributed wealth stashed in foreign subsidiaries, or as we could see in the Shandong case: Hong Kong. However, judging from the fact that many assets located in China are still owned by Hong Kong subsidiaries of Chinese SOEs, the CFC does not seem very effective in curbing the capital flight to Hong Kong. The continued use of these subsidiaries confirms the idea that the Chinese tax office has adopted a very friendly attitude towards profits from outbound investment.[112]

For loans and interest, Hong Kong is also a more beneficial place than China. For instance, the tax rates in China are higher, the DTAs favor Hong Kong when it comes to foreign withholding

[112] Yang Yating (2016), p. 677

taxes and China's Thin Capitalization rule hampers certain interest deductions. It is obvious why Hong Kong is more beneficial than China. As we could see in the British Virgin Islands case, Chinese SOEs prefer to use tax havens such as the BVI to route their wealth to and to finance their activities from. Some reasons may be that Hong Kong utilizes some sort of restrictions on certain interest deductions, and also in some cases the received interest can be taxed. This makes Hong Kong less preferable to finance activities from, that role has been taken over by BVI enterprises owned by the Chinese SOEs.

Not only the Chinese SOEs use entities situated in tax havens such as the BVI. Numerous Chinese Communist Party officials who are tied to Chinese SOEs also utilizes BVI entities. One example is Bo Xilai, a Chinese high-ranking official who was accused of using tax havens and was jailed for life on corruption charges in 2013.[113] Another example is the former chairperson of the SOE China Power International Development (CPID) Li Xiaolin.[114] She owns a BVI enterprise called COFIC Investments which earned its money 'from helping facilitate the export of industrial equipment from Europe to China.'[115] It is not known what kind of industrial equipment she helped exporting, but it could be for example the export of 4 600 MW steam turbines and generators from the French enterprise Alstom to the Hong Kong subsidiary[116] of CPID (called China Electric Power International Corporation) for the Pingwei Power Plant owned by CPID.[117] However, it is not known how COFIC Investments exactly could have earned the money with these kind of deals. These are just the tip of the iceberg when it comes to cases involving Chinese officials, SOEs and offshore tax havens. More research into such constructions is necessary, to see how much funds are kept out the reach of the Chinese tax authorities and to assess to what extent the Chinese state and society are harmed as a result of the ensuing tax evasion.

In conclusion, the role that Hong Kong subsidiaries can play in gaining tax benefits for Chinese SOEs is obvious. Hong Kong is a nexus in the flow of capital between China, third countries and tax havens such as the BVI. Taking in regard China's willingness to participate in the BEPS project, it seems improbable that it is the Chinese government's intention to facilitate a capital

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[113] Garside & Pegg (2016); Olesen (2016)
[114] CPID China Power International Development Limited (2004), p. 7: the daughter of former Chinese Premier Li Peng; ICIJ (n.d.)
[115] Olesen (2016)
[116] Xu Yi-Chong (2019), p. 102
[117] Alstom (2004); United States Securities and Exchange Commission (2004); CPID China Power International Development Limited (2004)

flow to tax havens. Rather, it is more likely that in the Chinese friendly attitude to outward investments, these unwanted effects are more or less taken for granted.

What we have seen is that a Hong Kong subsidiary often functions as a nexus in these financial dealings. I have already pointed out above, that these practices lead to possibly large-scale tax avoidance, not only in other countries than China and Hong Kong, but also in China itself. This, however, is not the only problem. Once these untaxed profits have ended up in offshore tax havens, it is no longer possible to follow the money. This untraceable money can subsequently be employed for all kinds of legal and less legal activities, such as the bribery of officials in other countries in order to get projects or better deals.[118] It is also possible that this money is used to simply buy political influence by bribing governments of "weak" countries or finance activities to destabilize countries which form a potential threat to China's long term goals in the international arena. In this regard it is even more interesting to investigate the involvement of Chinese officials in these business dealings.

[118] Transparency International UK (2014), p. 20

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Double Tax Agreements used for the DTA sets

All DTAs are retrieved from the International Bureau for Fiscal Documentation (IBFD): The given year is the year of signing, the following citation is applicable for all treaties: Belarus – Hong Kong Income Tax Agreement (2017), Treaties IBFD

Austria China	1991	Malaysia China	2012
Austria HK	2010	Malaysia HK	2012
Belarus China	1995	Malta China	2010
Belarus HK	2017	Malta HK	2011
Belgium China	2009	Mexico China	2005
Belgium HK	2003	Mexico HK	2012
Brunei China	2004	The Netherlands China	2013
Brunei HK	2010	The Netherlands HK	2010
Canada China	1986	New Zealand HK	2010
Canada HK	2012	New Zealand China (not in force)	2019
Czechia China	2009	Pakistan China	1989
Czechia HK	2011	Pakistan HK	2017
Finland China	2010	Portugal China	1998
Finland HK	2018	Portugal HK	2011
France China	2013	Qatar China	2001
France HK	2010	Qatar HK	2013
Hungary China	1992	Romania China	2016
Hungary HK	2010	Romania HK	2015
India China	1994	Russia China	2014
India HK	2018	Russia HK	2016
Indonesia China	2001	Saudi Arabia China	2006
Indonesia HK	2010	Saudi Arabia HK	2017
Ireland China	2000	South Africa China	2000
Ireland HK	2010	South Africa HK	2014
Italy HK	2013	Spain HK	2011
Italy China (not in force)	2019	Spain China (not in force)	2019
Japan China	1983	Switzerland China	2013
Japan HK	2010	Switzerland HK	2010
Korea (South) China	1994	Thailand China	1986
Korea (South) HK	2014	Thailand HK	2005
Kuwait China	1989	United Arab Emirates China	1993
Kuwait HK	2010	United Arab Emirates HK	2014
Latvia China	1996	United Kingdom China	2011
Latvia HK	2016	United Kingdom HK	2010
Luxembourg China	1994	Vietnam China	1995
Luxembourg HK	2007	Vietnam HK	2008