Tax memo

Canadian tax updates

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Canada signs treaty with Hong Kong: Good news for cross-border transactions

Provides an overview of the recently signed Canada-Hong Kong tax treaty.

November 13, 2012

On November 11, 2012, Canada and the Hong Kong Special Administrative Region of the People's Republic of China (Hong Kong) signed a new tax treaty (the Treaty) and related protocol.

The Treaty aims to remove tax barriers to encourage trade and investment between Canada and Hong Kong. In particular, it will:

- reduce the rates of withholding tax applicable to certain cross-border payments; and
- ensure that double taxation does not arise for individuals and companies doing business or earning income in the other jurisdiction.

As expected, the Treaty also contains an exchange of information article. The Treaty will enter into force once ratified by Canada and Hong Kong.

Highlights

The Treaty is based on the Model Tax Convention on Income and on Capital developed by the Organisation for Economic Co-operation and Development. Its signing occurred relatively quickly, considering that negotiations began only in mid-2011.

The reduced withholding tax rates on certain cross-border payments are outlined below.

Dividends	Interest	Royalties
5%[1] or 15%	0%[2] or 10%	10%

1. The 5% rate applies when the beneficial owner of the dividends is a company (other than a partnership) that directly or indirectly controls at least 10% of the voting power of the paying company. The 15% rate applies in all other cases.
2. The 0% rate applies on interest paid to:
   - various government bodies; and
   - a resident of the other country if the beneficial owner of the interest is a resident of the other country and is dealing at arm's length with the payer.

   The 10% rate applies in all other cases when the beneficial owner of the interest is a resident of the other country.

PwC observations*: The Treaty provides attractive reduced withholding tax rates in line with most of Canada's other treaties. With respect to dividends, the 5% rate is half of the withholding tax rate available under the current Canada-China (P.R.C.) Tax Treaty. Moreover, under Article 10(2)(a) of the Treaty, the 5% withholding tax rate on dividends extends to cases when the beneficial owner of the dividends is a company controlling directly or indirectly at least 10% of the voting power in the company paying the dividends. However, an anti-avoidance clause has been added to each of the "Dividends," "Interest"* *and "Royalties" articles to deny treaty benefits if one of the main purposes of certain transactions surrounding the payment is to obtain these treaty benefits.*

Entry into force

If ratified before December 31, 2012, the Treaty will apply:

- **In Hong Kong:** For any year of assessment beginning on or after April 1, 2013, in respect of Hong Kong Special Administrative Region tax.
- **In Canada:**
  - On or after January 1, 2013, in respect of tax withheld at source on amounts paid or credited to non-residents.
  - For taxation years beginning on or after January 1, 2013, in respect of other Canadian tax.
- **To shipping, air transport and capital gains:** Article 8 (Shipping and Air Transport) and paragraph 3 of Article 13 (Capital Gains) will be effective from the date the Treaty enters into force.

PwC observations*: The Treaty is a welcome addition to Canada's treaty network. Canadian corporate taxpayers have been waiting for some time for Canada to enter into a tax treaty with Hong Kong so that Hong Kong can be considered a "designated treaty country" for purposes of Canada's foreign affiliate rules. Active business earnings of a foreign affiliate resident in a designated treaty country can qualify as exempt earnings and be repatriated back to Canada tax-free. For purposes of these rules, once the Treaty enters into force, it will be deemed to have entered into force for the 2012 fiscal year (the year of signing).*

For more help

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