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India's new tax treaty with Hong Kong - Implications and Opportunities

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India and Hong Kong have recently signed a long awaited tax treaty which will significantly impact MNCs, funds and entrepreneurs with respect to investments and transactions between the two countries. The treaty will come into force in the tax year following notification by both parties.

So far, a majority of investors have invested into India from Singapore, Mauritius, Netherlands and Cyprus largely because of beneficial tax treaties between India and these countries. Although there have been strong economic connections between Hong Kong and India for decades, the absence of a tax treaty has always been a risk factor for investors.

The new treaty is likely to stimulate investments between the two countries and lend support to Hong Kong based structures. This is also an interesting development in light of the base erosion and profit shifting (BEPS) initiative being implemented globally which challenges conventional offshore holding structures in favour of 'substance-driven' planning.

In this update, we highlight key implications of the new India-Hong Kong tax treaty for MNCs, funds and wealthy families.

A. Investing into India

Gains from the sale of Indian securities are typically taxed in India at rates between 10-40%. Till April 1, 2017 residents of Mauritius, Singapore and Cyprus benefited from a capital gains exemption under the respective treaties with India, which ceased to be available from this date. The new tax treaty with Hong Kong also does not provide any capital gains tax relief on sale of Indian securities.

The Hong Kong treaty also does not provide relief against tax on indirect share transfers, which is available in other treaties. For example, a Hong Kong resident may be subject to tax in India on transfer of shares in a Singapore company if the value of such shares are substantially derived from assets in India (such as an Indian subsidiary). The treaty also does not provide relief against capital gains tax on transfer of other assets such as debt instruments or interests in limited liability partnerships (LLP). Lately, several MNCs have considered setting up LLPs (rather than companies) in India for captive operations because of the ease of repatriating capital from India and absence of the dividend distribution tax.

The treaty with Hong Kong reduces withholding tax on interest to 10% which could otherwise be as high as around 40%. This is lower than the 15% rate available under the Singapore tax treaty but higher than the 7.5% rate in the Mauritius treaty. Debt is often considered a tax efficient route to fund operations in India despite the interest deduction caps introduced last year. Indian regulatory norms have been gradually easing up debt investment routes making it easier to structure intra-group loans, debentures and bonds. Loans and debt investments from Hong Kong residents to India may now benefit from the treaty. Certain foreign source interest is also not taxable in Hong Kong which has a territorial tax regime.

Unlike most Indian tax treaties, the new treaty with Hong Kong recognizes pass-through vehicles such as limited partnerships and trusts, which makes it interesting for funds and other investors to explore using such vehicles for investing into India from Hong Kong.

Relief under the new treaty is subject to anti-avoidance and anti-treaty shopping rules. India's general anti-avoidance rules would also apply in parallel. These rules target investment structures that are entirely tax driven and lack commercial substance. For claiming treaty relief, a resident of Hong Kong should also obtain a tax residency certificate (TRC) from the Inland Revenue Department (IRD). The IRD is known to scrutinize TRC applications more closely with a view to checking whether activities and decision making are actually carried out in Hong Kong.

India and Hong have not yet signed an investment protection agreement, which can often be a key consideration while structuring investments into emerging economies like India. Presently, residents of countries like Singapore and Mauritius can benefit from various investor protections including fair and equitable treatment, compensation against expropriation and bilateral dispute resolution. Investment treaty protection is especially relevant to investors based in countries like China or the US which do not have investment treaties with India.

B. Impact on business operations

1. *Permanent establishments (PE)*

India has been continuously widening domestic rules for creating a taxable presence. Under these rules, foreign enterprises are taxed on profits derived from a 'business connection' in India, a threshold that is vague and broader than the concept of 'permanent establishment' (PE) under a tax treaty. The new treaty should provide relief to Hong Kong based MNCs and businesses since they can now transact with Indian parties or invest with more certainty on PE related tax risks. It is also helpful to Indian business groups that have set up holding and investment structures in Hong Kong but have potential tax exposure because of activities in India.

Hong Kong based fund managers may also benefit from the defined PE criteria in the tax treaty which provides more certainty on whether certain actions of their Indian advisory entities can potentially create a taxable presence in India. A recent amendment to Indian domestic law expands the agency PE concept to persons in India who are actively involved in contracts that are ultimately concluded by the overseas enterprise. The treaty with Hong Kong may provide relief against such wider notions of PE. This may also be relevant when determining whether Hong Kong based funds have a taxable presence in India by employing certain algo-trading strategies or co-location servers for investments in India.

Recently, India introduced a 'significant economic presence' test which would potentially tax overseas enterprises merely by virtue of the size of their Indian revenues and customer base, even if they do not have a fixed base, agents or employees in India. Technology companies view this as some sort of a 'virtual PE' concept. The PE threshold under the India-Hong Kong tax treaty is narrower and should provide relief to Hong Kong based enterprises transacting with India.

2. *Relief from withholding taxes*

In a number of cases, Indian tax authorities have sought to tax various payments to Hong Kong based residents, including broadcasting fees, software licenses, professional and technical service fees on the basis of wide source rules and definitions under Indian domestic law.

The tax treaty will provide more certainty to Hong Kong residents since the scope of taxable royalties and technical services under the treaty is based on internationally accepted principles and are generally narrower than domestic law. For example, under such principles, satellite broadcasting fees and software licenses without transfer of copyrights should not be subject to Indian withholding tax if the Hong Kong resident does not have a PE in India.

Airline operators in Hong Kong would be exempt from Indian taxes on profits from international air transport. Hong Kong residents earning profits from international shipping transport arising from sources in India would only be liable to 50% of applicable Indian taxes. Hong Kong based partnerships without a fixed base in India may seek treaty relief against Indian withholding tax on income from professional services.

C. Considerations for wealthy families

There is a sizeable community of wealthy families of Indian origin based in Hong Kong. The certainty on PE thresholds should provide relief, especially to those having family members and business interests in India. This may also be relevant to families having funds and family offices managed from Hong Kong.

With the recognition of Hong Kong resident trusts and partnerships under the treaty and certain regulatory changes in India, some non-resident Indian families may explore such vehicles for holding assets in India for the purpose of asset protection and succession planning.

For being considered a resident under the treaty, an individual has to be ordinarily resident in Hong Kong or should have stayed in Hong Kong for at least 180 days in a 300 day period over two consecutive assessment years. 'Ordinary residence' generally refers to a substantial presence, permanent home or habitual abode in Hong Kong.

The treaty introduces a wide framework for exchange of information for income tax matters as well as proceedings relating to customs, goods and services tax. While the exchange may only relate to tax years after the treaty's effective date, data relating to prior years may be shared if it is relevant to an audit of a tax year after this date.

Conclusion

Hong Kong serves as an important gateway to China as well as a platform for Chinese enterprises going outbound. The new treaty makes Hong Kong a more interesting hub for investing into India, one of the world's fastest growing economies.

While the treaty is unlikely to replace jurisdictions such as Singapore, there is an expectation that it will provide a boost to trade and investment between Hong Kong and India.

Notes

- Indian tax rates mentioned here are exclusive of applicable surcharge and cess

- This update is not a detailed analysis or recommendation with respect to investments or transactions between Hong Kong and India. The comments and analysis may vary depending on the facts and circumstances of each transaction.

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