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Russia and Hong Kong Tax Treaty Creates a Favorable Investment Climate

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It is hoped that the tax treaty between Russia and Hong Kong will improve economic relations between the countries and increase their level of transparency.

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When taking a decision to invest in a business within Russia, one should also take into account the tax aspects. Such aspects to a large extent depend on the form of investment and on the jurisdiction of which the investing company is a resident. It is worth mentioning that, unlike some other countries, the taxation of investments in Russia is practically not industry-specific (i.e. it is immaterial in which industry the money is invested). However, industry- and region-specific features can certainly have a dramatic influence on the taxation of a Russian enterprise which is the target for investments.

Investing both by establishing a new Russian company and by acquiring shares and membership interests in an existing company does not cause tax to be assessed on the investor. However, already when the decision to invest is taken, the implications of such a decision need to be considered in-depth, including the taxation of the income that the investor will subsequently gain: dividends, the allocated funds in event that the company is liquidated, and the income if the investor sells shares or membership interests in the enterprise.

On July 29, 2016 the treaty took effect between the Government of the Russian Federation and the Government of the Hong Kong Special Administrative Region of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income ("Treaty"), as did the Protocol to such Treaty. In Russia, the Treaty has been applied since January 1, 2017.

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An analysis of this Treaty reveals that in general it establishes more favorable conditions for the taxation of income gained by Russian and Hong Kong companies than many other similar treaties, including as compared with the Treaty between Russia and the People's Republic of China that was signed in 2014 and effective on January 1, 2017.

Below is a summary of the key provisions of this Treaty.

Tax Imposed when Dividends are Paid

Article 10 of the Treaty establishes a beneficial rate of 5 percent for residents of the contracting states if the actual recipient of the dividends owns at least 15 percent of the capital of the company that pays the dividends. In all other cases, the withholding tax rate is 10 percent.

The Treaty does not specify a minimum amount of investments for the 5 percent rate to be applied unlike Russia's other treaties (including the Treaty with the People's Republic of China). Therefore, for the beneficial rate to be applied, only one formal criterion must be complied with—the amount of the share (only 15 percent) in the issued capital, which makes the beneficial rate more widely available.

Tax Imposed when Interest is Paid

Article 11 of the Treaty establishes the principle that interest is subject to taxation only in the state where the recipient of the interest is located. Therefore, if a Hong Kong company finances a Russian company by providing loans, the interest paid to the former in Russia is not subject to taxation. In the absence of the Treaty this interest would have been taxed at the rate of 20 percent.

Tax Imposed when Royalties are Paid

The Treaty establishes a special withholding tax rate with respect to royalties (income from copyright and licenses)—3 percent. This rate is half the 6 percent rate under the Treaty between Russia and the People's Republic of China.

Tax Imposed when a Company which Owns Real Estate is Sold

The Treaty contains provisions that prevent real estate from being sold tax-free under the guise of shares or membership interests in an enterprise owning such real estate. Thus, if most of the Russian company's value is represented by real estate, the income from the sale of its shares in Russia is not subject to taxation only in the following three cases:

(i) if the shares are transferable shares being traded on a stock exchange;

(ii) if the shares have been disposed of or exchanged during a reorganization, merger, or split-up of the company or a similar operation; and

(iii) if the company performs its business activity in such real estate.

In other cases, the sale of shares or membership interests in a Russian company whose assets are mainly in the form of real estate is subject to taxation in Russia at the rate of 20 percent.

Avoidance of Double Taxation

In cases when the same income is subject to taxation both in Russia and in Hong Kong, tax paid in Hong Kong may be set off when tax is paid in Russia, and vice versa. This is the mechanism for avoiding double taxation provided for by many tax treaties.

Fighting Tax Abuse

Some articles of the Treaty, namely the articles regarding dividends, interest and royalties contain a provision against tax abuses. Thus, beneficial conditions are not applied if one of the main goals or the main goal of the party to which the income is paid is to obtain tax benefits under the Treaty. This approach is in line with the modern realities of international taxation and is supported by many countries.

Moreover, neither Russia nor Hong Kong face any limitations with respect to their right to apply national legislation and measures to fight tax evasion. Therefore, in addition to the above criterion (the main goal of the parties when consummating transactions and operations), tax authorities may apply provisions of national legislation and may implement judicial doctrines aimed at fighting tax abuses.

Since in recent years many countries have been striving to fight against tax abuses (the so-called BEPS Plan), it should be taken into account that the companies that count on benefits under the Treaty when they receive income should not be nominal or transit companies. Now numerous such schemes are checked by the Russian tax authorities, which, if they have any doubt, refuse to grant the benefits. Therefore, each decision to invest must be analyzed from the standpoint of its tax implications. Being careless about investing by creating intermediate structures may entail the assessment of additional taxes and fines.

The procedure for the competent authorities of the contracting states to exchange information is regulated separately in Article 25 of the Treaty. The Protocol extends the list of taxes as compared with those listed in the Treaty. The provisions on the exchange of information also apply to such taxes. The specified list includes VAT, corporate property tax and personal property tax.

Any documents provided within the framework of the exchange of information as well as a certificate of tax residency in Hong Kong do not require consular certification or a Russian apostille, including if they are to be used in courts and by state authorities. This significantly simplifies any formal legal procedures in which such documents are used.

In July 2017 Hong Kong entered Russia in its list of partners for the automatic exchange of information. The process of the automatic exchange of information is expected to start from 2018.

Therefore, the new Treaty creates conditions for the development of cooperation between Russia and Hong Kong by reducing expenses to attract and serve external borrowed funds. The Treaty takes into account that Russian investors are interested in the resources of one of the world's major stock exchanges (the Hong Kong Stock Exchange) as well as that Hong Kong business is interested in participating in Russian investment projects. We believe that the Treaty will improve economic relations between the countries and increase their level of transparency.

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