Watson, Farley & Williams

Hong Kong - Italy: Tax Treaty

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Introduction

On January 14, 2013 an Agreement was signed in Hong Kong between the Government of the Hong Kong Special Administrative Region of the People's Republic of China ("Hong Kong") and the Government of the Italian Republic ("Italy") for the avoidance of double taxation with respect to taxes on income and the prevention of tax evasion ("Agreement"). The Agreement, signed by Professor K C Chan, Secretary for Financial Services and the Treasury, on behalf of the Government of Hong Kong, and by Professor Vittorio Grilli, Minister of Economy and Finance, on behalf of the Italian Government, will enter into force only after the exchange of instruments of ratification between the two countries. Ratification usually occurs 18 months or more after the signing of the Agreement.

Scope of the Agreement

The Agreement, which aims to avoid double taxation on income and to avoid tax evasion, will be applicable only to the taxes referred to in the Agreement. In Hong Kong, this concerns profits tax, salaries tax and property tax. In Italy, the Agreement covers the current personal income tax (Irpef), corporate income tax (Ires) and regional tax on productive activities (Irap).

Agreement structure

The most interesting provisions in the Agreement structure, which substantially conforms to the OECD Model Tax Convention, include the following:

> a tie-breaker rule to eliminate conflicts of dual residency;

> a term of six months for the project permanent establishment to be triggered;

> determination of the dividend, interest and royalties rates at either 10, 12.5 or 15 percent. These rates dictate the maximum amount of tax on so-called 'passive income', and are imposed by the state in the jurisdiction where the income is derived;

> a clause relating to the taxation of income derived from professional services or other independent activities of similar nature. This grants the powers to tax such activities to the country of the fixed base in which the professional has derived that income, provided that they

have stayed more than 183 days in that country. It should be noted that this clause constitutes a discrepancy from the OECD Model Tax Convention, which has been in use since 2000. Since then, OECD has confirmed that as there is no difference between "permanent establishment" and "fixed base", as referred to in Articles 7 and 14 of the previous OECD Model Tax Convention. As such, OECD deemed the inclusion of the two provisions in the Model Convention unnecessary. However, their inclusion in the Agreement was considered to be appropriate in order to make the Agreement itself consistent with this clause. In particular, Article 6 on income from immovable property applies also to immovable property used for the performance of independent personal services and Article 13 on capital gains applies also to the income deriving from the alienation of movable property pertaining to the fixed base of the person performing independent personal services;

- absence of the clause on taxation of capital (as provided for in Article 22 of the OECD Model Tax Convention);
- use of the "ordinary credit method" for the avoidance of double taxation, combined with the "exemption with progression" method;
- a clause on the exchange of information on request, rather than automatic (or routine) exchange of information.

Key features of taxation in Hong Kong

It is worth mentioning that taxation in Hong Kong is based on the territorial source principle. Therefore, both residents and non-residents are only subject to tax in Hong Kong on income which arises in or is derived from Hong Kong.

Resident and non-resident companies with a permanent establishment in Hong Kong are subject to profits tax of 16.5 percent.

Dividends and interest paid by companies resident in Hong Kong to non-resident companies without a permanent establishment in Hong Kong are not subject to withholding tax. The royalties paid by companies resident in Hong Kong to non-resident (unrelated) companies are subject to a withholding tax of 4.95 percent. This rate increases to 16.5 percent if the royalty payment is between related parties.

There is no tax on capital gains.

Certain types of cross-border income covered by the Agreement

In the light of the above, Hong Kong resident companies will benefit most from the reduced withholding tax rates provided for in the Agreement regarding passive income derived in Italy (e.g. dividends, interest and royalties). In fact, given that in Italy the domestic withholding tax rate applicable to outbound dividends and interest is 20 percent, Hong Kong residents will benefit from the reduced tax rates regarding dividends and interest – 10 percent and 12.5 percent, respectively. The royalties subject to tax in Italy at a rate of 22.5 percent will be subject to a reduced rate of 15 percent when paid to Hong Kong residents.

One advantage of the Agreement for Italian and Hong Kong companies is that enterprises in the international maritime and air transport sectors will be taxable only in their country of residence.

Possible removal of Hong Kong from Italy’s blacklist and its consequences

The signing and ratification of the Agreement could lead Italy to remove Hong Kong from its blacklist, which was drafted to prevent specific kinds of tax evasion. The removal of

Hong Kong from the blacklist would abolish, *inter alia*, the applicability of the following:

> non-deductibility of costs incurred by companies resident in countries with a favourable tax regime (so-called blacklisted countries) – note that paragraph 3 of Article 23 of the Agreement relating to the non-discrimination clause should have immediate effect with the result that this regime would not apply. This is also confirmed by recent case-law;
> controlled foreign companies (CFC) rules currently applicable to controlled companies resident in blacklisted countries;
> rules regarding the full taxation of intercompany dividends;
> rules regarding the full taxation of capital gains deriving from the sale of shares in companies resident in blacklisted countries.

Conclusion

The Agreement, when ratified, is expected to boost trade activities and reinforce economic ties between Italy and Hong Kong. Furthermore, as a result of the Agreement, Hong Kong will have the potential to become an ideal jurisdiction for the establishment of subholding companies for Italian investments in Asia, particularly in China and North East Asia.

Moreover, thanks to its growing network of double taxation treaties (which currently totals 27 different countries), a particularly favourable domestic tax regime, and considering the recent phenomenon of European companies transferring their tax residence abroad due to the high level of taxation in many EU countries, Hong Kong could soon become one of the most preferred tax jurisdictions for European enterprises.

Contacts

Watson, Farley & Williams, thanks to its presence both in Italy and Hong Kong, and its specific expertise, offers legal advice and tax planning services to businesses based in Italy wishing to invest in Hong Kong and vice versa.

Should you like to discuss any of the issues raised in this briefing, please get in touch with Eugenio Tranchino, Head of Italy, Raffaele Villa, Head of Tax in Italy, or Federico Fabiano at our Italy Desk in Hong Kong.

Eugenio Tranchino, LL.M.
Head of Italy
Milan
etranchino@wfw.com
T: +39 027217071
M: +39 3382694360

Raffaele Villa, LL.M.
Head of Tax, Italy
Milan
rvilla@wfw.com
T: +39 027217071
M: +39 3392729789

Federico Fabiano, LL.M.
Italy Desk
Hong Kong
ffabiano@wfw.com
T: Hong Kong +852 21686700
M: Hong Kong +852 53680004

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