

PricewaterhouseCoopers' commentary

A solution to eliminate double taxation affecting cross-border employees

September 2010



It has been 12 years since the Arrangement for the Avoidance of Double Taxation (the "DTA") entered between the Governments of Mainland China (the "Mainland") and the Hong Kong Special Administrative Region came into effect. Despite one of the key objectives of the DTA being to "eliminate" double taxation on employment income earned by Hong Kong residents working across the border, in practice, there are indeed situations where double tax has been paid on the same income. In this article, we will look into this issue closely and provide suggestions as to how these circumstances could be eliminated.

The problem

Let us take the example of a Hong Kong resident with a permanent home and family in Hong Kong who is employed by a Hong Kong company

and seconded to work full time on the Mainland, say, as a general manager of a factory on the Mainland. His travel details are as follows:

Workdays spent on the Mainland	226
Non-workdays spent on the Mainland	10
Workdays spent in Hong Kong (i.e. two meetings per month)	24
Non-workdays spent in Hong Kong	105
Total days in a year	365

On the Mainland, he would be subject to individual income tax ("IIT") in full on his employment income even though he returns to Hong Kong during weekends and holidays and occasionally (say two days in each month) reports duties to his boss in

Hong Kong. This is because he only has one job and in general, IIT will be imposed on his full income regardless of whether his salary is fully paid inside or outside of the Mainland as virtually all services required by his position (except for the twice a month reporting meetings held in Hong Kong) are rendered on the Mainland.

On the other hand, in Hong Kong, he would need to apply for income tax relief (commonly known as “Section 8(1A) (c) claim”) as he spends more than 60 days in Hong Kong in a year of assessment and performs services (i.e. the reporting meetings) in Hong Kong. While the Section 8(1A) (c) claim is intended to exempt the portion of employment income attributable to services rendered in another tax jurisdiction where income tax on the same income has been paid, the calculation method is not clearly specified in the Inland Revenue Ordinance (“IRO”) and therefore it is the prevalent practice of the Hong Kong Inland Revenue Department (“IRD”) to generally adopt a “physical day basis” to apportion the income that would be subject to Hong Kong salaries tax (“HKST”).

In the above example, if the employee receives an annual income of HK\$1,000,000 (assuming there is no bonus), his tax position on the Mainland and Hong Kong under the current practice would be as follows:

Under current practice	Hong Kong	Mainland
Total employment income	HK\$1,000,000	
Percentage of income allocated to each location (based on 365 days)	$\frac{(365 - 236) \text{ days}}{365 \text{ days}} = 35\%$	100%
Portion of income subject to tax in each location	HK\$350,000	HK\$1,000,000
Portion of income being double taxed	HK\$350,000	

As you will see from the above, even if his total employment income has already been fully taxed (i.e. 100%) on the Mainland, he is still subject to HKST on about 35% of his employment income because the IRD would normally exclude 65% of his income from HKST on the basis that he only spends 236 days out of 365 days (or 65% of his time) on the Mainland.

The problem of double taxation exists because the State Administration of Taxation (“SAT”) and IRD have different interpretations based on their respective domestic laws in determining the source of income and yet taxpayers are often unable to ask the respective tax authorities to resolve the problem according to the established procedures set out in the DTA. However, in our view, the adoption of the “**workday basis**” to apportion the employment income may be a simpler and workable solution to eliminate the double taxation issue and it is also in line with the sourcing principle currently adopted by international practice (including the UK and US tax authorities).

Under the “**workday basis**” methodology, it is suggested that both the Mainland and Hong Kong will impose IIT and HKST according to the actual workdays spent in the respective locations as shown below:

Suggested approach	Hong Kong	Mainland
Total employment income	HK\$1,000,000	
Percentage of income allocated to each location (based on total workdays)	$\frac{(250 - 226) \text{ days}}{250 \text{ days}} = 10\%$	$\frac{226 \text{ days}}{250 \text{ days}} = 90\%$
Portion of income subject to tax in each location	HK\$100,000	HK\$900,000
Portion of income being double taxed	Nil	

Following from the above, only 90% (as opposed to 100% in the previous example) of his income would be taxable on the Mainland; while only 10% (as opposed to 35% in the previous example) would be taxable in Hong Kong. Accordingly, the issue of the 35% of income being double taxed would be eliminated. For the ease of comparison, the above analysis is prepared on an annual basis. However, unlike HKST which is assessed on an annual basis, IIT on employment income is assessed on a monthly basis. Hence, when applying the above workday basis methodology on the Mainland, the nominator and denominator of the apportionment formula should reflect the workdays in the Mainland and the total workdays of the month respectively. Despite this, the principle and outcome of the above analysis should be the same.

Another typical scenario which may give rise to significant double taxation is where a cross-border employee receives an annual bonus. According to the IIT law, despite the monthly salary being able to be time apportioned under certain circumstances, bonuses cannot be time apportioned on a day-in-day-out basis. Instead, it is only when the employee does not spend a single workday on the Mainland in the complete calendar month(s), that the portion of the bonus that is attributable to such calendar month(s) can be excluded from IIT.

There are in fact many real life examples of significant double taxation on bonuses where the Hong Kong employee only spends minimal workdays on the Mainland but is subject to IIT because he fails to meet all the requirements in order to qualify for income exemption under the DTA. Let us take the example of a Hong Kong employee who is also registered as a chief representative in a representative office on the Mainland. Assuming he only spends four work days each month (i.e. a total of 48 working days a year) on the Mainland and receives a big annual bonus of HK\$2,000,000, his tax position of the bonus on the Mainland and Hong Kong would be as follows:

Under current practice	Hong Kong	Mainland
Bonus entitlement	HK\$2,000,000	
Percentage of bonus allocated to each location (based on 365 days)	$\frac{(365 - 48) \text{ days}}{365 \text{ days}} = 87\%$	100%
Portion of bonus subject to tax in each location	HK\$1,740,000	HK\$2,000,000
Portion of bonus being double taxed	HK\$1,740,000	

In the above example, the bonus is double taxed because the SAT seeks to tax the bonus in full if the taxpayer spends even a day a month on the Mainland over the period during which the bonus is earned. Hence, again, the issue can be resolved if the SAT and IRD agree to apportion the bonus according to the workdays spent in the respective locations (see below).

Suggested approach	Hong Kong	Mainland
Bonus entitlement	HK\$2,000,000	
Percentage of bonus allocated to each location (based on total workdays)	$\frac{(250 - 48) \text{ days}}{250 \text{ days}} = 81\%$	$\frac{48 \text{ days}}{250 \text{ days}} = 19\%$
Portion of bonus subject to tax in each location	HK\$1,620,000	HK\$380,000
Portion of bonus being double taxed	Nil	

The double taxation issue is not exclusive to Hong Kong residents working on the Mainland, however, we plead that special apportionment methodology should be given to this group of cross-border employees because of the closer proximity between the Mainland and Hong Kong which leads to the need for frequent and regular visits than residents from other parts of the world. More importantly, as Hong Kong is already part of the Mainland, it would not be considered equitable or necessary to double tax a person on the same income within a single country.

The way ahead

As we embrace the “one-hour quality living sphere” concept to be brought about by the completion of the Hong Kong Section of Guangzhou-Shenzhen-Hong Kong Express Rail Link and Hong Kong-Zhuhai-Macao Bridge, it is inevitable that cross-border activities (whether for business and / or personal) will be significantly increased in the near future. If the SAT and IRD are willing to consider a more liberal interpretation and implementation of the tax rules on income apportionment as suggested above, the economic effect of the change can be enormous without significant changes to the tax laws.

In executing the workday methodology for both income and bonus apportionment as suggested above, the following factors could be considered in arriving at the nominator and denominator of the income apportionment formula:

- A full workday is attributed to the location where the individuals spend working most of the day.
- A half workday is attributed to the location where the individuals spend working half of the day.
- Leisure time spent in a location during non-office hour and holidays is excluded.
- Working time spent in a location during holidays should also be reported as a workday based on an honest self-reporting system.

In addition, while a complete removal of the 183-day income exemption threshold may be seen as unreasonable, we urge that certain relaxation of the threshold can be considered for the Pearl River Delta given the increasingly integrated economic and social community within the Pearl River Delta region and Hong Kong. There have been many cases of Hong Kong residents working for not more than 183 days on the Mainland but were dragged into the Mainland tax net because they also spent holidays and weekends on the Mainland for social activities. We therefore suggest that a more lenient way for counting the 183 days be adopted by the Pearl River Delta region tax authorities for residents of Hong Kong. For example, non-workdays (or simply public holidays), holidays and weekends spent in the Pearl River Delta region by Hong Kong residents are excluded from the counting of the 183-day threshold. On the same token, the same should apply to Mainland residents spending holidays and weekends in Hong Kong.

Should the above suggestions be adopted, it is envisaged that the following benefits may arise:

- Individuals are taxed in a simpler and fairer way.
- Double taxation is removed.
- Social and investment activities between the two territories are motivated.
- Talent mobility between the two territories is fostered and encouraged.

Contacts

Berin Chan

Partner, Hong Kong

+852 2289 5504

berin.db.chan@hk.pwc.com

Jacky Chu

Partner, Hong Kong

+852 2289 5509

jacky.chu@hk.pwc.com

PwC International Assignment Services — Asia Region

We are a strategic alliance of International Assignment Services (“IAS”) practices formed under a single management team, covering China, Hong Kong, Malaysia, Singapore, Taiwan, Thailand and Vietnam. This combined structure gives us the ability to provide seamless services on cross-border assignment issues throughout the Asia region, in addition to our global PwC network. The regional structure puts us in the best possible position to leverage our specialised staff and resources across the region, especially taking advantage of our expertise within the local markets.

With over 530 professionals, the largest fully-integrated IAS practice in Asia, we are leaders in expatriate compensation and benefits, tax planning and compliance, assignment management, policy design and review, employer tax compliance review and global visa services. Our unique structure allows us to deliver a breadth of service offerings to our clients with the solutions they need to become a successful business in Asia.

About PricewaterhouseCoopers — Globally

PricewaterhouseCoopers (www.pwc.com) provides industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 163,000 people in 151 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

pwcias.com