Hong Kong and Estonia sign income tax treaty

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Hong Kong signed a comprehensive income tax treaty with Estonia (the Treaty) on 25 September 2019.

The key provisions of the Treaty are highlighted below.

Promoting trade and investment

The Treaty contains provisions which reduce or eliminate withholding taxes on certain passive income between the two jurisdictions.

The following table summarizes the applicable withholding rates for passive income when received from Estonia by a Hong Kong resident as beneficial owner.[1]

Passive Income/ Tax rate	Dividends	Interest	Royalties	Fees for technical services	Capital gains on disposal of shares
Normal withholding rate for companies	0%	0%	10%	10%	0/20%[2]
Reduced rate under the Treaty	0%	0%	5%	0%	0%[3]

Avoidance of double taxation

When the income of a Hong Kong resident is subject to tax in both Hong Kong and Estonia, the Hong Kong resident can credit the tax paid in Estonia against the Hong Kong tax liability arising on the same income. The available tax credit is, however, limited to the Hong Kong tax imposed on the same income.

Lower dependent agency permanent establishment (Agency PE) threshold

Under the Treaty, in addition to the current provision of "habitually concludes contracts,"[4] a dependent agent who "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" will be sufficient to constitute an Agency PE.

Under the Treaty, an agent who acts "exclusively or almost exclusively on behalf of one or more enterprises to which the agent is closely related" will be considered as a dependent agent.[5]

Entitlement to benefits

Under the principal purpose test, tax benefits otherwise granted under the Treaty will be denied if it is reasonable to conclude that one of the principal purposes of an arrangement or transaction is to obtain a benefit under the Treaty.

Effective date of the Treaty

The Treaty will enter into force in the tax year following the calendar year in which the ratification procedures are completed by both jurisdictions. Assuming the ratification procedures are completed in 2019, the Treaty will become effective as follows:

- Hong Kong: for any taxable year beginning on or after 1 April 2020
- Estonia: for any income year beginning on or after 1 January 2020

Endnotes

1. Hong Kong's withholding rate is 0% on dividends, interest, fees for technical services and capital gains; 4.95% on royalties.
2. Nonresident companies without a permanent establishment in Estonia are taxed at 20% on capital gains derived from a source in Estonia. However, capital gains derived from sales of shares and securities by nonresidents are exempt from tax, except for the alienation of a certain equity interests in a land-rich Estonian company.
3. Capital gains on the disposal of shares in an Estonian company derived by a Hong Kong resident investor will generally be exempt from tax in Estonia. However, if at any time during the 365 days preceding the disposal, the shares are in respect of a company holding substantial immovable property located in Estonia, the capital gain will be subject to tax unless the shares were quoted on a specified stock exchange.
4. Currently, the Treaty provides that when a dependent agent of an enterprise of a contracting party, who habitually acts on behalf of the enterprise and has, and habitually exercises, an authority to conclude contracts in the name of the enterprise in the other contracting party, that enterprise will be deemed to have an Agency PE in the other contracting party.
5. The term "closely related" is broadly defined in the Treaty as follows: "based on all the relevant facts and circumstances, one [party] has control of the other or both are under the control of the same persons or enterprises..."

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