The Mainland and Hong Kong signed the Fifth Protocol to the Mainland/Hong Kong Double Taxation Arrangement

News Flash
Hong Kong Tax
August 2019
Issue 5

In brief

On 19 July 2019, the Commissioner of the State Taxation Administration (STA), Mr. Wang Jun, and the Financial Secretary of the Hong Kong Special Administrative Region (Hong Kong), Mr. Paul Chan, signed the Fifth Protocol to the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (Mainland/HK DTA) (the Fifth Protocol) in Beijing. The Fifth Protocol will enter into force upon the written notifications by both sides of the completion of their respective required ratification processes.

The Fifth Protocol mainly introduces changes in the following two areas:

- incorporating the recommendations in the Base Erosion and Profit Shifting (BEPS) action reports released by the Organisation for Economic Co-operation and Development (OECD), including amendments to the preamble and certain articles, such as Resident, Permanent establishment, Capital gains, etc.; and
- adding a new “Teachers and researchers” article to grant tax exemption to teachers or researchers of one side for eligible remuneration received for services performed in the other side along with a new “principal purposes test” (PPT) article on prevention of treaty abuse.

In this news flash, we have summarised the main contents of the Fifth Protocol and shared with you our observations on its impact from the Hong Kong tax perspective.

In detail

The main contents of the Fifth Protocol and its impact from the Hong Kong tax perspective

Article 4 Resident

In determining the residency status of a person other than an individual who is a tax resident of both sides, the existing Mainland/HK DTA looks at the person’s place of effective management. The Fifth Protocol amends this tie-breaker rule and replaces it with the mutual agreement procedure through which the STA and the Hong Kong Inland Revenue Department (IRD) shall endeavour to determine the tax residency of such person by taking into accounts its place of effective management, the place where it is incorporated, or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by the Mainland/HK DTA.
Our observations

The Fifth Protocol provides a mechanism to address the situation when an entity is a tax resident of both Hong Kong and the Mainland, for example a Hong Kong incorporated company which is partly managed in Hong Kong and partly managed in the Mainland. Although the STA and the IRD can discuss and determine the tax residency status of the company by mutual consent, it is also possible that no agreement is reached. In the latter case, the involved entity will not be protected by the Mainland/HK DTA and may have to consider to change its management structure so that it is no longer viewed as a tax resident of one side.

Article 5 Permanent Establishment

The Fifth Protocol adopts the recommendations in the final report of BEPS Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status), which introduces a wider definition for permanent establishment (PE) constituted through an agent (Agency PE):

- **Widening the scope of Agency PE**: Under the existing Mainland/HK DTA, where a person is acting as a dependent agent of an enterprise of a contracting party and habitually exercising an authority to conclude contracts in the other contracting party in the name of the enterprise, that enterprise shall be deemed to have a PE in the other contracting party. The Fifth Protocol extends the scope of Agency PE to include not only “conclusion” of contracts, but also habitually “plays the principal role leading to the conclusion of contracts” that are routinely concluded without material modification by an enterprise. Going forward, a Chinese enterprise shall be deemed to have a PE in Hong Kong if these contracts are:
  1. in the name of the Chinese enterprise; or
  2. not in the name of the Chinese enterprise, but for the transfer of the ownership of, or for the granting of the right to use, property owned by that Chinese enterprise or that Chinese enterprise has the right to use; or
  3. not in the name of the Chinese enterprise, but for the provision of services by that Chinese enterprise.

- **A stricter definition for “independent agent”**: The Fifth Protocol provides a more precise definition for independent agent, which states that if a person “acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related”, that person shall not be considered to be an independent agent. It further states that “closely related” refers to direct or indirect control of more than 50%.

Our observations

Types 2) and 3) Agency PE situations mentioned above are new in the Fifth Protocol. Technically they can be described as commissioner arrangement, which is defined in BEPS Action 7 report as “an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products”. Neither the STA nor the IRD has officially released their interpretations or guidance on such arrangements. As such, there are uncertainties on how the competent tax authorities of both sides would deal with the above-mentioned types 2) and 3) Agency PE.

Tightening of the “independent agent” definition to cover the situation where a person exclusively or almost exclusively negotiates contracts in Hong Kong on behalf of a closely related Mainland enterprise (even if such person does not “conclude” the contracts) heightens the risk for the Mainland enterprise being deemed as having a PE in Hong Kong and the risk that the profits derived from these contracts being subject to tax in Hong Kong.

Article 13 Capital Gains

The Fifth Protocol applies a more precise wording for gains from the alienation of shares. According to the existing Mainland/HK DTA, gains derived by a Chinese tax resident from the alienation of shares in a company may be taxed in Hong Kong, if at any time within the 3 years before the alienation, these shares derived not less than 50% of the value, directly or indirectly, from immovable property situated in Hong Kong. The Fifth Protocol clarifies that this article applies not only to shares in a company, but also to comparable interests, such as interests in a partnership or trust. This is in line with the international practice where “the (shares of a) company, (interests in a) partnership or trust” refers to a company, a partnership, a trust established anywhere in the world.

It is clear from the amended Article 13 of the Mainland/HK DTA that the IRD has the right to tax the relevant gains from the alienation of such comparable interests derived by a Chinese tax resident.

In addition, the Fifth Protocol slightly changes the percentage of value derived from immovable property from “not less than 50%” to “more than 50%” and clarifies that the term “immovable property” in this clause should be by reference to the definition of “Immovable Property” in Article 6 of the Mainland/HK DTA, which is in line with the international practice.

Our observations

Even the Fifth Protocol grants the taxing right to Hong Kong on such gains (for example, gains derived by a Chinese investor from transfer of interests in a trust mainly invested in Hong Kong real estate), the relevant provisions of Hong Kong Inland Revenue Ordinance (IRO) would still need to be observed in determining whether such gains are subject to tax in Hong Kong, in particular, whether such gains could be considered as capital in nature and excluded from Hong Kong profits tax under section 14 of the IRO.
Article 18(A) Teachers and Researchers

The Fifth Protocol introduces a new article, Article 18(A), which provides China individual income tax exemption for a period of three years for remuneration received by a Hong Kong resident individual employed by a university, institute, school in Hong Kong, or any other educational or research institution officially recognised in Hong Kong ("eligible institution") from his/her Hong Kong employer and who stays in the Mainland mainly for the purpose of teaching or engaging in research in an eligible institution in the Mainland, provided that such remuneration is taxable in Hong Kong. After the expiration of the exemption period, such remuneration would be taxable in the Mainland according to the STA’s interpretation.

Although the IRD has not published guidance on the scope of eligible institutions, STA Public Notice [2016] No.91 has shed some light on this arrangement. Specifically, except for training institutions, schools offering pre-school education, elementary education, secondary education, higher education and special education are all eligible.

Our observations

Before the signing of the Fifth Protocol, the IRO has already been amended to introduce Section 8(1AB) in March this year. The effect of the section is that for a Hong Kong resident individual who derives income from services rendered by him/her as a visiting teacher or researcher in a DTA jurisdiction, including the Mainland, if he/she has enjoyed tax exemption on the above mentioned income under the relevant DTA, then even if his/her “visits” to Hong Kong is not more than 60 days in the year of assessment concerned, he/she will not be eligible for the “60-Day Rule” exemption under section 8(1A)(b) of the IRO. The amendment will apply to any year of assessment commencing on or after 1 April 2019.

The introduction of section 8(1AB) in the IRO and the Article 18(A) in the Mainland/HK DTA is to ensure the income of the Hong Kong teachers and researchers visiting the Mainland will be taxed in Hong Kong only but not in the Mainland and to prevent double taxation as well as “double non-taxation”. Hence Hong Kong teachers or researchers who receive remuneration from their Hong Kong employers for teaching or engaging in research in an eligible institution in the Mainland and pay Hong Kong salaries tax on their remuneration (Section 8(1AB) of the IRO) are exempt from individual income tax for such remuneration for a period of three years in the Mainland (Article 18(A) of the Mainland/HK DTA).

The introduction of Article 18(A) is good news to teachers and researchers engaging in academic exchange and scientific research collaboration between the Mainland and Hong Kong.

Preamble language and Article 24(A) Entitlement to Benefits

To prevent the abusive use of treaty benefits, the Fifth Protocol amends the language used in the preamble of the Mainland/HK DTA which emphasises that in addition to the elimination of double taxation, the purpose of the Mainland/HK DTA is also to prevent non-taxation or reduced taxation through tax evasion or avoidance.

In this regard, the Fifth Protocol also adds a new Article 24(A), the PPT article, under which a benefit under the Mainland/HK DTA shall not be granted in respect of an item of income if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Mainland/HK DTA.

The takeaway

Following the Mainland’s signing of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) on 7 June 2017, the Mainland and Hong Kong have respectively released their “provisional MLI positions” with an aim to swiftly modify bilateral tax treaties to implement BEPS recommendations on treaty-related aspects. However, as the Mainland/HK DTA is only an arrangement between two territories but not a double tax agreement between two sovereign countries, it is not covered by the MLI.

The Mainland and Hong Kong have gone through bilateral negotiation of the Fifth Protocol, which amends the relevant articles in the Mainland/HK DTA with a view to incorporating the relevant suggestions in the MLI. The Fifth Protocol results in more stringent requirements on anti-tax avoidance and anti-treaty shopping.

With the adoption of the PPT as suggested by the OECD, treaty benefits under the Mainland/HK DTA will be denied if the main purpose or one of the main purposes of any persons concerned is to take advantage of the relevant articles. Taxpayers with cross border business are strongly encouraged to examine the tax implications brought by the Fifth Protocol to their business models and consult competent professionals where necessary.

Endnotes

1. The Chinese of the Article 18(A) and Article 24(A) are 第十八條（附）and 第二十四條（附）. There is no official English translation of the Fifth Protocol available yet.

3. Section 8(1AB) was introduced by the Inland Revenue (Amendment) (No.2) Ordinance 2019. Please refer to the link: https://www.legco.gov.hk/yr18-19/english/ord/2019ord006-e.pdf

4. Income from services rendered in Hong Kong during “visits” not exceeding a total of 60 days in a year of assessment is excluded from tax in Hong Kong. A “visit” means a short or temporary stay. Whether the nature of a trip to Hong Kong made by a Hong Kong resident is a visit or not depends on the circumstances of each case. In general, if a Hong Kong resident has a work base outside Hong Kong and is required to station outside Hong Kong to render services, the person’s occasional return to Hong Kong might be considered as a visit.

5. The newly added Article 24(A) has replaced the Article 4 of the Fourth Protocol of the Mainland/Hong Kong DTA (which applies the PPT to the dividends, interest, royalties and capital gains articles only) and expanded the scope of the PPT to apply generally to all articles.

6. For details of the MLI and the Hong Kong SAR Government’s stance on treaty abuse, please refer to our Hong Kong Tax News Flash, June 2017, Issue 6 which can be accessed via this link: https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-jun2017-6.html

7. The changes made by the Fifth Protocol are not exactly the same as the positions taken by the Mainland and Hong Kong in the MLI.
Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

PwC’s Corporate Tax Leaders based in Hong Kong

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone Number</th>
<th>Email Address</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charles Lee</td>
<td>+852 2289 8899</td>
<td><a href="mailto:charles.lee@cn.pwc.com">charles.lee@cn.pwc.com</a></td>
</tr>
<tr>
<td>Jeremy Ngai</td>
<td>+852 2289 5616</td>
<td><a href="mailto:jeremy.cm.ngai@hk.pwc.com">jeremy.cm.ngai@hk.pwc.com</a></td>
</tr>
<tr>
<td>Jeremy Choi</td>
<td>+852 2289 3608</td>
<td><a href="mailto:jeremy.choi@hk.pwc.com">jeremy.choi@hk.pwc.com</a></td>
</tr>
<tr>
<td>Rex Ho</td>
<td>+852 2289 3026</td>
<td><a href="mailto:rex.ho@hk.pwc.com">rex.ho@hk.pwc.com</a></td>
</tr>
<tr>
<td>Cecilia Lee</td>
<td>+852 2289 5690</td>
<td><a href="mailto:cecilia.sk.lee@hk.pwc.com">cecilia.sk.lee@hk.pwc.com</a></td>
</tr>
<tr>
<td>Jenny Tsao</td>
<td>+852 2289 3617</td>
<td><a href="mailto:jenny.np.tsao@hk.pwc.com">jenny.np.tsao@hk.pwc.com</a></td>
</tr>
<tr>
<td>Kenneth Wong</td>
<td>+852 2289 3822</td>
<td><a href="mailto:kenneth.wong@hk.pwc.com">kenneth.wong@hk.pwc.com</a></td>
</tr>
</tbody>
</table>

PwC’s International Tax Advisory Team

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone Number</th>
<th>Email Address</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jeremy Ngai</td>
<td>+852 2289 5616</td>
<td><a href="mailto:jeremy.cm.ngai@hk.pwc.com">jeremy.cm.ngai@hk.pwc.com</a></td>
</tr>
<tr>
<td>David Smith</td>
<td>+852 2289 5802</td>
<td><a href="mailto:david.g.smith@hk.pwc.com">david.g.smith@hk.pwc.com</a></td>
</tr>
</tbody>
</table>
In the context of this News Flash, China, Mainland China or the PRC refers to the People’s Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PwC’s client service team or your other tax advisers. The materials contained in this publication were assembled on 8 August 2019 and were based on the law enforceable and information available at that time.

This News Flash is issued by the PwC’s National Tax Policy Services in China and Hong Kong, which comprises of a team of experienced professionals dedicated to monitoring, studying and analysing the existing and evolving policies in taxation and other business regulations in China, Hong Kong, Singapore and Taiwan. They support the PwC’s partners and staff in their provision of quality professional services to businesses and maintain thought-leadership by sharing knowledge with the relevant tax and other regulatory authorities, academies, business communities, professionals and other interested parties.

For more information, please contact:
Matthew Mui
+86 (10) 6533 3028
matthew.mui@cn.pwc.com

Please visit PwC’s websites at http://www.pwccn.com (China Home) or http://www.pwchk.com (Hong Kong Home) for practical insights and professional solutions to current and emerging business issues.