HONG KONG TAX

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MAINLAND AND HKSAR SIGN FIFTH PROTOCOL TO ARRANGEMENT FOR AVOIDANCE OF DOUBLE TAXATION

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On 19 July 2019, the Financial Secretary, Mr Paul Chan, and the Commissioner of the State Taxation Administration, Mr Wang Jun, 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 ("China-HK DTA") in Beijing.

The Fifth Protocol shall enter into force after the completion of ratification procedures and notification by both Mainland and Hong Kong governments. It is expected to take effect for years of assessment commencing 1 April 2020.

This newsletter summarizes the important changes brought by the Fifth Protocol from a Hong Kong perspective. Please contact BDO tax team to discuss how we may assist you in revisiting existing business structures and operational structures.

Important changes brought by the Fifth Protocol

1. Change in the tie-breaker provision in dual residence scenarios

According to the existing Resident article (i.e. Article 4) of the China-HK DTA, if a person, except in the case of natural persons, is a resident of both the Mainland and Hong Kong, its residence for the purposes of the China-HK DTA should be determined by the situs of its place of effective management.

The Fifth Protocal amends Article 4(3) such that the residence of such person for the purposes of the China-HK DTA will be determined by agreement between the competent authorities of both sides after considering: (i) the place of effective management, (ii) the place of incorporation or establishment and (iii) all relevant facts and circumstances. Importantly, if the competent authorities cannot come to an agreement, the applicant is not eligible for any benefit or relief under the China-HK DTA. This amendment is largely consistent with the latest approach in the Resident article in the Organisation for Economic Co-operation and Development ("OECD") Model Tax Conventioin dated 21 November 2017.

2. Expansion of the definition of agency permanent establishment

The definition of an agency permanent establishment in Article 5 (5)-(6) is expanded to include, in addition to habitually concluding contracts for a non-resident party, habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise; and the contracts are:

(i) in the name of the enterprise;

(ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by the enterprise or that the enterprise has the right to use; or

(iii) for the provision of services by the enterprise;

unless the activities are limited to activities that if exercised through a fixed place of business would not make the fixed place of business a permanent establishment according to Article 5(4), and unless in acting for the non-resident person, the resident person is carrying on business in Hong Kong as an independent agent in its ordinary course of that business. Note that a person is not an independent agent for this purposes if the person acts exclusively, or almost exclusively, on behalf of one or more enterprises that are closely related to the person.

This expansion mirrors the provisions under Section 7(1) of Schedule 17G – Meaning of Permanent Establishment in Hong Kong for determining agency permanent establishment of a non-DTA territory resident, which was introduced into the Inland Revenue Ordinance with effect from 13 July 2018.

3. Strengthening the provisions of anti-tax treaty abuse

Article 24 (Additional) is added to preclude any benefit or relief from being granted if the relevant arrangement or transaction is reasonably determined to have one of its principal purposes to obtain tax benefit or relief under the China-HK DTA after all relevant facts and circumstances are considered, unless the granting of tax benefit or relief in such case is consistent with the China-HK DTA's objectives and purposes.

The objectives and purposes of the China-HK DTA are also restated in the preamble of the China-HK DTA through this Fifth Protocol. The revised language now explicitly states that the intention of the China-HK DTA is not to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping where a resident of a third party state obtains tax benefit hereunder).

4. Tax relief for qualified teachers and researchers across border

Article 18 (Additional) is added to provide tax exemption to qualified teacher and researchers who are employed in one side and engages in teaching and research activities on the other side for a period of three years, provided that the relevant income has been subject to tax on the side where the person concerned is employed.

BDO observations

The Fifth Protocol introduces important changes in the China-HK DTA for which cross-border businesses should carefully review their present business model against potential increased tax exposures. For a Hong Kong company with management partly or wholly located in China, it may be completely ineligible for tax benefits under the China-HK DTA unless the competent authorities of both sides agree that it is a Hong Kong resident. The lowered threshold for the dependent agency permanent establishment could lead to Hong Kong companies being regarded as having a permanent establishment in Mainland China because of services provided by a subsidiary. The new general anti-avoidance provisions in Article 24 (Additional) will have impact when a taxpayer claims any tax benefits under the China-HK DTA including reduced withholding tax on dividends, interest or royalties, and exemption from capital gains tax in China.

The Fifth Protocol will be effective from the year of assessment 2020/21, assuming ratification procedures will be completed by 31 March 2020. Taxpayers who want to be able to avail of the tax reliefs and benefits under the China-HK DTA are highly encouraged to restructure and/or strengthen their substances in Hong Kong as soon as possible.

Please contact BDO tax team to discuss.

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