



# Hong Kong Tax Alert

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## Mainland China and Hong Kong signed the Fifth Protocol to their Comprehensive Avoidance of Double Taxation Arrangement (CDTA)

*In addition to granting tax relief for visiting teachers or researchers of one contracting party working in the other contracting party, the Fifth Protocol also introduces provisions to prevent tax treaty abuse in accordance with the latest international standards.*

*The more significant anti-treaty abuse provisions introduced are: (i) a lower threshold for a dependent agency permanent establishment (DAPE); and (ii) a general anti-abuse provision based on the "one of the principal purposes test" (PPT) in substitution of the current "main purpose test" of an arrangement.*

*Taxpayers should assess how the Fifth Protocol will impact their existing business arrangements and operational structures and seek professional tax advice where necessary.*

## The Fifth Protocol

On 19 July 2019, mainland China and Hong Kong signed the Fifth Protocol to their Comprehensive Avoidance of Double Taxation Arrangement (the CDTA). The amendments under the Fifth Protocol are summarized below.

### **Emphasizing CDTA is not intended to create opportunities for non-taxation or reduced taxation**

The Fifth Protocol replaces the original Preamble, or introductory statement, of the CDTA with a version that aligns with the language recommended under the Organization for Economic Co-operation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) Action 6 Final Report (Preventing Treaty Abuse).

Unlike the original Preamble, the revised version explicitly states that the intention of the CDTA is also not to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance. Specifically, it is intended that treaty-shopping arrangements aimed at obtaining reliefs provided in the CDTA for the indirect benefit of residents of a third state should be denied.

### **Dual residence of a non-individual entity to be resolved by mutual agreement**

Under the Resident Article (Article 4) of the existing CDTA, the dual residence of an entity other than an individual (e.g., companies and partnerships) is addressed by a tie-breaker rule that deems the entity to be a resident of the jurisdiction in which its place of effective management is situated.

The Fifth Protocol replaces the aforesaid tie-breaker rule by a mutual agreement approach on a case-by-case basis. Under such an approach, where a person other than an individual is a dual resident of the two contracting parties, the competent authorities of mainland China and Hong Kong shall endeavor to determine, by mutual agreement, the place of residence of which such person shall be deemed to be a resident for the purposes of the CDTA. Such determination shall be made having regard to the place of effective management of the entity, the place where the entity was incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such an entity shall not be entitled to any relief or exemption from tax provided by the CDTA except to the extent and in such manner as may be agreed upon by the competent authorities of the two contracting parties.

## Lower Dependent Agent Permanent Establishment threshold

Currently, paragraph 5 of the Permanent Establishment Article (Article 5) of the CDTA provides that where 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 a DAPE in the other contracting party.

Under the Fifth Protocol, in addition to the current provision of "habitually concludes contracts", 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 a DAPE. This change aligns with OECD BEPS Action 7 recommendation in respect of DAPE, even though Hong Kong has "opted out" of the optional provisions in relation to OECD BEPS Action 7 under the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting which is applicable to CDTAs that Hong Kong has signed with jurisdictions other than mainland China.

In this context, the Fifth Protocol also explicitly states that the relevant contracts can be contracts in respect of (i) the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or (ii) the provision of services by that enterprise.

Furthermore, the Fifth Protocol also broadens the circumstances under which an agent will be considered as a dependent agent, thereby constituting a DAPE.

Currently, it is only where the activities of an agent are "wholly or almost wholly performed on behalf of an enterprise of a contracting party" will such an agent be considered as a dependent agent. Under the Fifth Protocol, where an agent acts "exclusively or almost exclusively on behalf of one or more enterprises to which the agent is closely related", such an agent will be considered as a dependent agent.

The term "closely related" is broadly defined in the Fifth Protocol 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..."

Whilst the Fifth Protocol adopts the DAPE definition in OECD BEPS Action 7, it has not adopted the relevant changes in relation to anti-fragmentation and the splitting up of contracts in the determination of a PE.

## **Disposal of shares or comparable interests in a land-rich entity**

Unlike Hong Kong, capital gains are taxable in mainland China. As such, a resident of Hong Kong who disposes of shares in a “land-rich” company is liable to tax in mainland China and will not be exempt from tax in mainland China under the existing CDTA.

The Fifth Protocol now explicitly states that the taxing rights of mainland China in this regard will not be confined to shares in a company, but will also include comparable interests in other entities such as partnerships and trusts.

Nonetheless, the definition of a “land-rich” entity is slightly relaxed under the Fifth Protocol from “50% or more” of the underlying assets of an entity being immovable property situated in mainland China, to “more than 50%”.

## **Newly added Article on Teachers and Researchers**

The Fifth Protocol introduces a new Teachers and Researchers Article (Article 18) to the CDTA. Under this new article, a qualified teacher or researcher, who is employed in Hong Kong or mainland China and engages in teaching and research activities on the other side, shall be exempt from taxation on that 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.

It should be noted that income of such a teacher or researcher, which is exempt from tax in mainland China under Article 18 of the CDTA, will nonetheless be taxable in Hong Kong under the newly enacted provisions contained in sections 8(1A)(b) and 8(1AB) of the Inland Revenue Ordinance. Such a charge to tax in Hong Kong will still apply even though during a year of assessment the teacher or researcher concerned performs their services wholly outside Hong Kong.

## **Introduction of PPT to deny entitlement to tax benefits otherwise obtained**

The Fifth Protocol replaces the current specific provision for anti-treaty abuse which is applicable only to the Articles on Dividends, Interest, Royalties and Capital Gains, with a general provision for anti-treaty abuse, i.e., a PPT that applies to all the Articles of the CDTA.

Under the PPT, tax benefits otherwise granted under the CDTA will be denied where it is reasonable to conclude that one of the principal purposes of an arrangement or transaction is to secure a benefit under the CDTA. The PPT would nonetheless not apply if it is established that granting of such benefits in the circumstances would be in accordance with the object and purpose of the relevant provisions of the CDTA.

## **Effective date of the Fifth Protocol**

The Fifth Protocol will only come into force in the tax year following the calendar year in which the relevant ratification procedures are completed. Assuming that the ratification procedures can be completed in 2019, the Fifth Protocol shall then have effect as follows:

- a) in Hong Kong: for any year of assessment beginning on or after 1 April 2020;
- b) in mainland China: for any tax period beginning on or after 1 January 2020.

## **Commentary**

With the lower DAPE threshold under the Fifth Protocol, Hong Kong resident enterprises that rely on persons in mainland China to undertake certain activities before they enter into business contracts inside or outside mainland China, may need to reassess their situations, i.e., reassess whether the activities of those persons would exceed the lower DAPE threshold and thus expose them to taxation in mainland China.

Furthermore, any tax arrangements involving the CDTA may also need to be re-examined. This would particularly be the case given that the PPT will be more difficult to satisfy than the previous specific provision for anti-treaty abuse.

Taxpayers should consider how the Fifth Protocol will impact their existing business arrangements and operational structures and seek professional tax advice where necessary.

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