

China Tax & Investment News

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Fifth Protocol to Mainland-HK DTA signed

Article on Teachers and Researchers is
newly introduced and threshold on
Dependent agent PE is lowered



Recently, the Mainland of China and the Hong Kong SAR signed the Fifth Protocol to the Mainland-HK Double Taxation Arrangement (DTA)¹. According to the Mainland-HK DTA, the Fifth Protocol shall, upon the written notifications by both sides of the completion of their respective required approval procedures, enter into force on the date of the later of these notifications.

Recently, the Mainland of China and the Hong Kong SAR signed the Fifth Protocol to the Mainland-HK Double Taxation Arrangement (DTA)¹. The Protocol brings about new benefits for teachers and researchers but it makes easier the triggering of a dependent agent permanent establishment (PE). According to the Mainland-HK DTA, the Fifth Protocol shall, upon written notification by both sides of the completion of their respective required approval procedures, enter into force on the date of the later of these notifications.

This issue of China Tax & Investment News aims to discuss the main changes that the Protocol brings about and share our views thereon.

Major changes

Pursuant to the Fifth Protocol, major changes made to the Mainland-HK DTA are as follows:

- ▶ Preamble - amendment is made to clarify the purposes of the Mainland-HK DTA
- ▶ Article on Resident - a mutual agreement approach shall be adopted to solve dual residence
- ▶ Article on Permanent Establishment (PE) - threshold on Dependent agent PE is lowered
- ▶ Article on Capital Gains - applicable scope is extended to cover partnerships and trusts
- ▶ Article on Teachers and Researchers - newly added to grant treaty benefit to qualified personnel
- ▶ Principal Purposes Test (PPT) - expanded to apply to all provisions

Note:

1. 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, which was signed on 21 August 2006



Preamble – Purposes of the HK-Mainland DTA

The original Preamble in Mainland-HK DTA is modified in the Fifth Protocol to elaborate on the purposes of this DTA, which are to prevent non-taxation or reduced taxation through tax evasion or avoidance in addition to avoiding double taxation. It is worth noting that the new Preamble clearly states that those “treaty-shopping arrangements” aimed at obtaining reliefs provided in this DTA for the indirect benefit of residents of a third state should be denied.

Treaty shopping shall refer to arrangements through which a person who is not a resident of a Contracting State may attempt to obtain benefits that a treaty grants to a resident of that State. Treaty shopping cases typically involve persons who are residents of third States attempting to access indirectly the benefits of a treaty between two Contracting States through certain arrangements.

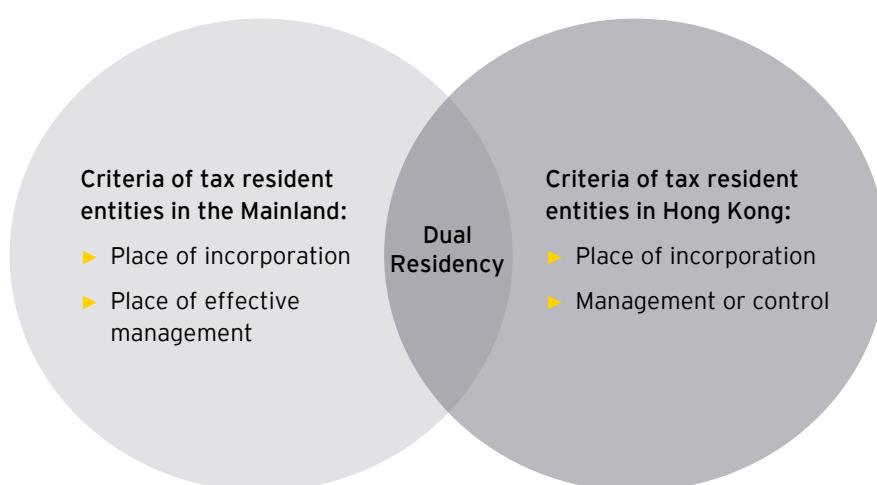
The revisions to the Preamble in the Fifth Protocol are in line with the requirements and standards mandated by the OECD Base Erosion and Profit Shifting (BEPS) Actions.

Dual resident entities – endeavor to solve by mutual agreement

The Fifth Protocol revises relevant provisions on determining the resident status for a dual resident entity, that is, how to determine the resident status of a person other than an individual who satisfies both definitions of residency for Hong Kong and the Mainland as provided in the Mainland-HK DTA.

Considering the fact that both the Mainland and Hong Kong adopt a relatively wide-ranging rule for determining tax resident status, it seems quite easy to trigger a dual tax residence as simply falling within a criteria could cause a resident exposure to both sides, which could then result in double taxation (as shown in Figure 1). For example, an enterprise incorporated in Hong Kong with its effective management located in the Mainland, could constitute a “dual tax resident” of the entity in both Hong Kong and the Mainland according to the local rule of each side. In this situation, the coordination to deal with conflicts resulted from the “dual residence” would be triggered. Before the release of the Fifth Protocol, the Mainland-HK DTA adopted the criteria of place of effective management, that is, the residence status of an entity with “dual residence” shall be determined by the place where its effective management is located. Accordingly, the abovementioned enterprise should eventually be determined as a tax resident in the Mainland. This is consistent with the principle for determining dual resident status in the tax treaties signed between China and most countries.

Figure 1. Dual resident entities of the Mainland and Hong Kong





The Fifth Protocol does not deny the criteria of “place of effective management” but proposes more flexibility - clarifying that while dealing with these conflicts, competent authorities of the two contracting parties shall endeavor to determine, by mutual agreement, the 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 tax relief or exemption provided by the Mainland-HK DTA except to the extent and in such manner as may be agreed upon by the competent authorities of the contracting parties. In other words, the person may be entitled to the relief or exemption from tax provided by the Mainland-HK DTA where the competent authorities reach the agreement on the extent and manner according to the Mainland-HK DTA.

The revised rules for the conflicts of dual resident not only follows the OECD Model Tax Convention on Income and on Capital which was issued in December 2017 (the “OECD Model Tax Convention (2017 update)”) ² but reflects China’s position on the clause of Dual Resident in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting³. China adopted this clause in the tax treaties signed in recent years, such as the treaties with Argentina (signed on 2 December 2018), New Zealand (signed on 1 April 2019) and Italy (signed on 23 March 2019) as well as the Protocol to PRC-India DTA (signed on 26 November 2018).

Dependent agent PE – triggering threshold is lowered and an agent closely related to an enterprise / enterprises is considered as a dependent agent

Under the current PE provision in Mainland-HK DTA, an agent acting in a Contracting State on behalf of an enterprise of another Contracting State (“the enterprise”) and habitually exercises an authority to conclude contracts will constitute a PE in that State, unless the agent is an independent agent acting in the ordinary course of its business.

The Fifth Protocol lowers the threshold of triggering a Dependent agent PE mainly from the following two aspects:

- ▶ In addition to the abovementioned “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 PE, provided certain conditions are met
- ▶ Currently, an agent that wholly or almost wholly performed on behalf of an enterprise will be considered as a dependent agent, the Fifth Protocol expands the scope of the dependent agent by stipulating that “where an agent acts exclusively or almost exclusively for one or more enterprises to which it is closely related, the agent will be considered as a dependent agent”

Dependent agent

According to the Fifth Protocol, a dependent agent is deemed as constituting a PE if the following circumstances are met:

- ▶ An agent acts in One Side on behalf of an enterprise of the Other Side⁴;
- ▶ The agent habitually concludes contracts”, or habitually plays the principle role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise; and
- ▶ These contracts are
 - ▶ in the name of the enterprise; or
 - ▶ for 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
 - ▶ for the provision of services by that enterprise

The enterprise shall be deemed to have a PE in that One Side in respect of any activities that agent undertakes for the enterprise, unless the activities have a preparatory or auxiliary character (as prescribed in Paragraph 4, Article 5 of Mainland-HK DTA).

It is not unreasonable to expect that, the risk of constituting a Dependent agent PE could increase after the enactment of the Fifth Protocol.

Note:

2. https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_g2g972ee-en#page1

3. <http://www.chinatax.gov.cn/n810341/n810770/c2672578/content.html>

4. The terms “One Side” and “the Other Side” mean the Mainland of China or the Hong Kong Special Administrative Region (SAR), as the context requires



Independent agent

Under prevailing provisions, PE status will not be triggered where a non-resident enterprise carries on business in the country/region concerned via an independent agent. To avoid treaty abuse, a DTA usually provides the circumstances under which an agent shall not be deemed to be an agent of an independent status, thereby constituting a PE. Currently, an agent that wholly or almost wholly performed on behalf of an enterprise will be considered as a dependent agent, thus constituting a PE.

As mentioned above, the Fifth Protocol expands the scope of "dependent agent" by introducing the concept of a "person closely related to an enterprise".

A person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under control of the same persons or enterprises. The "control" here shall refer to, possesses directly or indirectly:

- ▶ more than 50% of the beneficial interest; or
- ▶ in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company

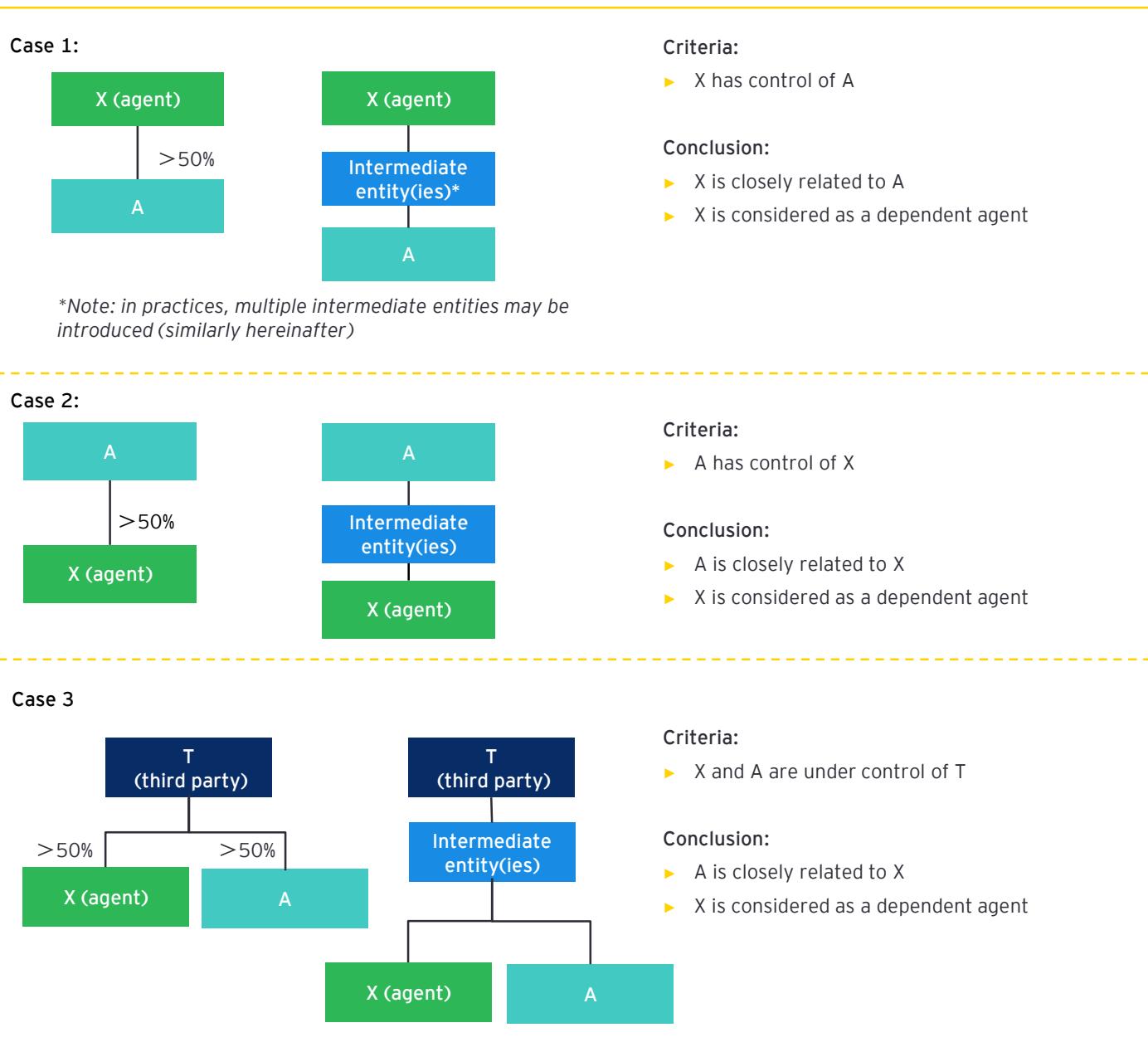
We try to illustrate in the figures below the circumstances under which an agent is closely related to an enterprise or enterprises, thereby the independent agent status shall not apply and a PE will be constituted accordingly.





Figure 2 An agent closely related to an enterprise or enterprises

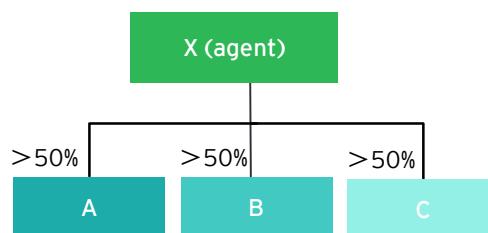
Scenario 1 Agent X acts exclusively or almost exclusively for Enterprise A





Scenario 2 Agent X acts exclusively or almost exclusively for Enterprises A, B and C

Case 4:



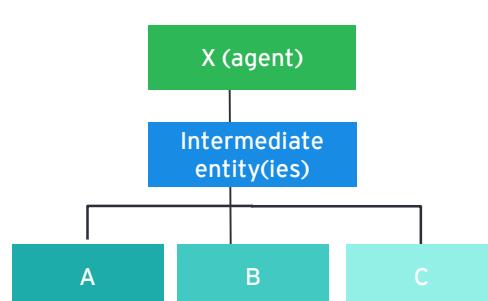
Criteria:

- X has control of A, B and C

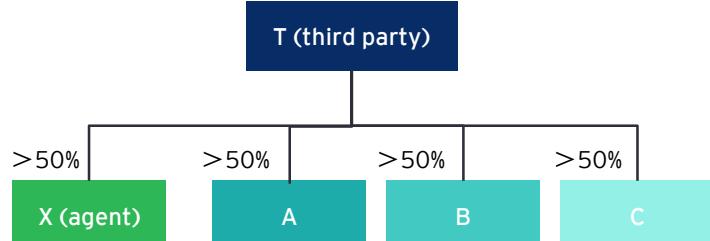
Conclusion:

- X is closely related to A, B and C
- X is considered as a dependent agent

Case 5:



Case 6:



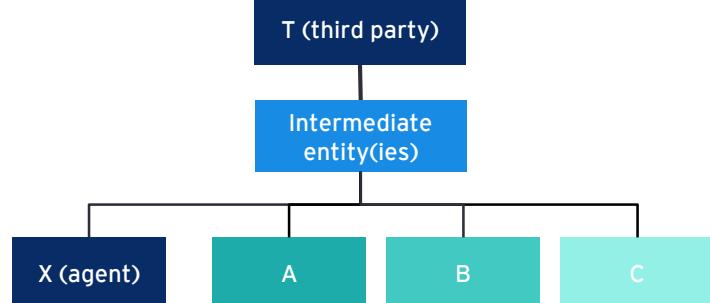
Criteria:

- X, A, B and C are under control of T

Conclusion:

- X is closely related to A, B and C
- X is considered as a dependent agent

Case 7:



The amendments to PE clause in the Fifth Protocol align with the OECD Model Tax Convention (2017 update) and Final Report of OECD/G20 BEPS Project - Action 7⁵. However, it is noted that the anti-fragmentation rule and anti-splitting up of contracts rule are not adopted in the Fifth Protocol.

Note:

5. Preventing the Artificial Avoidance of Permanent Establishment Status
<http://www.chinatax.gov.cn/download/2015g20/7.pdf>



Article on Capital Gains - applicable scope extended to partnerships and trusts

There is no capital gains tax in HK as that in Mainland China. In Mainland China, the income derived from transfer of immovable property shall be subject to Corporate Income Tax (CIT). It is noted that slight changes are made in the Fifth Protocol to Article on Capital Gains from two aspects:

- Relaxing the threshold by revising "50% or more" to "more than 50%"

According to the Fifth Protocol, gains derived by a HK resident from the alienation of shares or comparable interests shall be liable to tax in Mainland China if, at any time during the three years preceding the alienation, these shares or comparable interests derived 50% or more of their value directly or indirectly from immovable property. The Fifth Protocol slightly relaxed the threshold by revising "50% or more" to "more than 50%", which is to say, in case 50% of the value was derived from immovable property, the relevant capital gains shall not be subject to PRC CIT.

- Extending applicable scope to cover partnership and trusts

Currently the taxing right of Mainland China in this regard is only limited to the alienation of shares, but the Fifth Protocol extends the applicable scope to tax gains from the alienation of interests in partnerships or trusts, that do not issue shares, as long as more than 50% of the value of the interests is derived from immovable property.

Newly added Article on Teachers and Researchers - to provide qualifying remuneration received a three-year tax exemption

A significant amendment to the Mainland-HK DTA shall be the newly introduced Article on Teachers and Researchers. According to the Fifth Protocol, remuneration received by qualified teachers or researchers dispatched by One Side to the Other Side shall be exempt from income tax in that Other Side for a period of three years, provided certain criteria are met.

Qualified teachers and researchers

A qualified teacher or researcher shall be:

- an individual employed by a university, institution, school or any other educational or research institution officially recognized by the Government of One Side;
- is or was immediately before visiting the Other Side a resident of One Side; and
- is present in the Other Side solely for the purpose of teaching or engaging in research in a university, institution, school or any other educational or research institution officially recognized by the Government of that Side.

Remuneration eligible for tax exemption

Qualified remuneration shall be the remuneration:

- derived from teaching or researching (as mentioned above);
- paid by, or on behalf of the employer in that One Side; and
- has been taxed in that One Side.

It should be noted that tax exemption shall not apply to income from research, if this research is not for the public interest and is primarily for the private benefit of a certain person or persons. Another point worth-noting is that training institutions shall not be classified as education institutions⁶.

In addition to the treaty benefit, currently the Chinese government grants preferential IIT treatment to overseas (including Hong Kong, Macao and Taiwan) high-end talents and talents in short supply (the "talents") that work in Greater Bay Area (GBA). Subsidies will be granted by governments in the nine cities⁷ within GBA to the talents based on the IIT difference (i.e., the IIT payment exceeding 15% of the taxable income) and such subsidies are exempt from IIT.

Note:

6. The STA PN [2016] No. 91

7. Guangzhou, Shenzhen, Zhuhai, Foshan, Huizhou, Dongguan, Zhongshan, Jiangmen and Zhaoqing



Principle purpose test - apply to all provisions

The Fifth Protocol expands the applicable scope of the anti-treaty abuse rule - Principle Purpose Test (PPT), which is used to assess whether a treaty benefit shall be granted based on the principle purpose of transactions or arrangements. Currently, PPT under the Mainland-HK DTA covers only the benefits under specific articles (i.e., dividends, interest, royalties and capital gains). After the ratification of the Fifth Protocol, the PPT shall apply to all Articles of the Mainland-HK DTA.

According to the Fifth Protocol, a benefit under Mainland-HK DTA shall not be granted in respect of an item of income, if having regarded all relevant facts and circumstances, that is reasonable to conclude, that obtaining that the DTA 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 objective and purpose of the relevant provisions of this DTA.

Effectiveness and enactment

The Fifth Protocol shall apply to income derived in tax year of Mainland and Hong Kong respectively⁸, following that in which this Protocol enters into force. Fifth Protocol has yet to be ratified and it is expected that a public notice will be issued by the China STA to clarify the effectiveness and enactment of this Protocol.

Conclusion

The amendments to Mainland-HK DTA are primarily comprised of the OECD Model Tax Convention (2017 update) as well as the BEPS Package.

This amendment has followed the recent trend in tightening anti avoidance. Especially in the provision of lowering the triggering threshold of dependent agent, which aligns with the final report of BEPS Project - Action 7 and increase the risk of an enterprise constituting a permanent establishment in a contracting state. Thus, enterprises with cross border operation should take particular caution in managing the risk. For any situation that may create uncertainty on the tax position, an enterprise should consider reshuffle the operations in order to reduce the respective risk.

Following the establishment of GBA and the development of One Belt One Road policy, exchanges of talents, technology and academy created substantial value to both Mainland and Hong Kong. Many Hong Kong tertiary education institutions collaborate with the same level of academy through forming joint ventures or by launching programs to cultivate the manpower of both sides. However, due to the tax difference, it makes the cost of sending teachers from Hong Kong to the Mainland more expensive if the individuals are to be tax-equalized. That has caused travel by teachers to be undertaken in a more cautious manner. With the introduction of the Article on Teachers and Researchers in the Fifth Protocol, (which provides a three-year tax exemption for qualified persons,) it is not unreasonable to expect that the free flow of talents and resources between the Mainland and HK will be effectively enhanced following the enactment of the Protocol. This will accordingly promote closer cooperation and collaboration between the Mainland and Hong Kong, plus further creating more room for both sides to complement each other.

Note:

8. Tax year in Mainland: 1 January to 31 December; Tax year in Hong Kong: 1 April to 31 March of following year



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