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Newsletter Covering Technical Development in Taxation

THE FIFTH PROTOCOL TO THE COMPREHENSIVE AVOIDANCE OF DOUBLE TAXATION ARRANGEMENT BETWEEN MAINLAND CHINA AND HONG KONG

On 19 July 2019, Mainland China and Hong Kong signed the Fifth Protocol to their Comprehensive Avoidance of Double Taxation Arrangement (“DTA” or “Arrangement”). The protocol will take effect from the following calendar year upon the completion of the respective ratification procedures. For Hong Kong, it will be in the year of assessment beginning on or after 1 April; whilst for Mainland China, it will be the tax period beginning on or after 1 January.

In this Tax Flash, we will provide you with the salient points of the Fifth Protocol.

1. PREAMBLE OF THE DTA

The new version of the preamble explicitly stipulates that in addition to the elimination of double taxation, the purpose of the DTA is also to prevent non-taxation or reduced taxation through tax evasion or avoidance. This aligns with the recommendation under the Organization for Economic Co-operation and Development (“OECD”)’s Base Erosion and Profit Shifting (“BEPS”) Action 6 – Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. It applies to all articles in the DTA and should be taken into account when reviewing the changes made in the Fifth Protocol.

2. ARTICLE 4 - RESIDENT

In determining the residency status of an entity¹ who is a tax resident of both sides, the tie-breaker rule under the existing DTA is to look at where its place of effective management is situated.

¹ According to Article 3 of the DTA, “entity” refers to a company, a trust, a partnership and any other body of persons for tax purposes.

The Fifth Protocol now adopts a mutual agreement approach on a case-by-case basis which is recommended by BEPS Action 6 report². The factors that the competent authorities of mainland China and Hong Kong will look at to determine the place of residence of an entity includes (i) the place of effective management; (ii) the place of incorporation or otherwise constituted; and (iii) any other relevant factors. In case no agreement can be made by the competent authorities of both sides, such an entity shall not be entitled to any tax relief or exemption under the DTA except to the extent and in such manner as may be agreed upon by the competent authorities of both sides.

Entities with dual residency in Mainland China and Hong Kong (e.g. a company incorporated in Mainland China with effective management located in Hong Kong) are advised to review its current management and operational structures.

3. ARTICLE 5 - PERMANENT ESTABLISHMENT

The Fifth Protocol also incorporates changes which adopt the definition of dependent agent permanent establishment (“DAPE”) in OECD BEPS Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status).

Under the existing DTA, if a dependent agent of an enterprise of a contracting party habitually exercises an authority to conclude contracts in the name of that enterprise in the other contracting party, the enterprise shall be deemed to have a DAPE in the other contracting party.

The Fifth Protocol now extends the scope of DAPE to also include those dependent agents who habitually plays a predominant role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. In future, an enterprise of a contracting party shall deem to have a DAPE in the other contracting party if the related 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 enterprise has the right to use; or
- for the provision of services by that enterprise.

The above does not apply if the resident person (i) carries on business in the contracting party as an independent agent³; and (ii) acts for the enterprise in the ordinary course of that business.

BEPS Action 7 raised concerns over the tax avoidance strategies used to circumvent the former Model permanent establishment definition, such as arrangements through which taxpayers replace subsidiaries that traditionally acted as distributors by commissionaire arrangements, with a resulting shift of profits out of the jurisdiction where the sales took place but without a substantive change in the functions performed within that jurisdiction. This amendment in the DTA, by aiming to close this loophole, is a direct response to the specific situation stated in BEPS Action 7.

4. ARTICLE 13 - CAPITAL GAIN

Under the existing DTA, for gains derived from alienation of shares in a company, where these shares comprise not less than 50% (directly or indirectly) of the value from immovable property situated in one side at any time within three years before the alienation, it may be taxed in that one side.

² As stated in the BEPS Action 6 report, since dual resident entities may engage in tax avoidance arrangements, it is recommended that competent tax authorities should assess the situation on a case-by-case basis to avoid improper granting of treaty benefits.

³ The Fifth Protocol clarifies that a person shall not be considered as an independent agent if that person “acts exclusively on behalf of one or more enterprises to which it is closely related”. “Closely related” refers to direct or indirect control exceeding 50%.



The Fifth Protocol now clarifies that the Article is not confined to alienation of shares in a company; it also applies to comparable interests such as interest in a partnership and trusts. Besides, it relaxes the percentage of value derived from immovable property from “not less than 50%” to “more than 50%” and clarifies the term “immovable property” in Article 6 of the DTA to mean “real estate” (which in line with the 2017 OECD model tax convention).

5. ARTICLE 18(A) - TEACHERS AND RESEARCHERS

The Fifth Protocol introduces a new Article 18(A) for Teachers and Researchers. Under the article, a qualified teacher or researcher, who is employed by “eligible institution” 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.

The introduction of Article 18(A) eliminates one of the main obstacles for teachers and researchers from both sides in engaging in cross-border work, thus facilitating increased academic exchange and opportunities for scientific collaboration between Mainland China and Hong Kong, especially with the accelerated development of the Greater Bay Area. This new change is also expected to be crucial in attracting a new influx of Hong Kong research talent to Mainland Chinese educational institutions.

It should be noted that the Hong Kong Inland Revenue Ordinance (“IRO”) has already been amended to introduce Section 8(1AB) in March this year. The effect of the section is such that for an individual with Hong Kong residency who derives income from services rendered by him/her acting as a visiting teacher or researcher in a DTA jurisdiction (including Mainland China), they will not be exempt from taxation according to the “60-Day Rule” under section 8(1A)(b) of the IRO if his/her “visits” to Hong Kong do not exceed 60 days in the year of assessment concerned. This ensures that the remuneration will be taxed on at least one side. The amendment will apply to any year of assessment commencing on or after 1 April 2019.

6. ARTICLE 24(A) - ENTITLEMENT TO BENEFITS

A new Principal Purpose Test (“PPT”) article (Article 24(A)) is also introduced. Under the new article, a DTA benefit shall be denied if it is reasonable to conclude, having considered all relevant facts and circumstances, that obtaining such benefit (directly or indirectly) was one of the principal purposes of any arrangement or transaction, unless it is established that granting the benefit in these circumstances would be in accordance with the object and purpose of the relevant DTA provisions.

The introduction of PPT poses greater tax administration and compliance management challenges, especially for multinational corporations.

POINTS TO NOTE

Following the Fifth Protocol, it is predicted that there would be upcoming changes to other Hong Kong DTAs as well. Any tax arrangements involving the DTA needs to be thoroughly re-examined, especially considering the fact that the PPT will henceforth be more difficult to fulfil due to added precautions and more stringent measures against treaty abuse. Furthermore, it is projected that future uncertainties may emerge over the following areas: determining the tax residence of dual resident entities through mutual agreement, risks resulting from changes to what constitutes DAPE, and how the PPT is to be applied on each case. Taxpayers should study how the Fifth Protocol will impact their existing business arrangements and operational structures and seek professional assistance and making relevant adjustments where necessary.

RSM Tax Advisory (Hong Kong) Limited

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- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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