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# HONG KONG TAX ALERT

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## Hong Kong signs new protocol to China tax agreement

**Summary**

Hong Kong and China have signed the Fifth Protocol to the Hong Kong-China Double Tax Agreement which introduces tax exemption to qualified teachers and researchers as well as anti-avoidance provisions on treaty abuse.

The Fifth Protocol provides tax exemption to qualified teachers and researchers, who is employed in Hong Kong or China and engages in teaching or research activities on the other side, for a period of three years.

The Fifth Protocol also extends the definition of permanent establishment to prevent treaty abuse and to correspond with the recent update in transfer pricing rules in Hong Kong.

There are also updates in tie-breaker rule in respect of dual residence of a person other than individual as well as provisions related to capital gains.

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 (“the DTA”) entered into force on 8 December 2006 and has been supplemented by a number of subsequent protocols in 2008, 2010 and 2015.

On 19 July 2019, Hong Kong and China have signed the Fifth Protocol to the DTA (“the Fifth Protocol”) which provides tax relief to qualified Hong Kong and China teachers and researchers. The latest protocol is important for the training, exchange of talents and cooperation in scientific research between the parties. The Fifth Protocol also incorporates measures to prevent tax treaty abuse, which form part of the Base Erosion and Profit Shifting (“BEPS”) package promulgated by the Organisation for Economic Co-operation and Development (“OECD”) to ensure that the DTA follows the latest standard of international tax rules.

We give a brief overview of the main implications below.

### Tax exemption to qualified teachers and researchers

A new article (Article 18) related to teachers and researchers is added to the DTA under the Fifth Protocol. Under this article:

- a qualified teacher or researcher, who is employed by the qualified education or research institution in one side; and
- engages in teaching or research activities for qualified education or research institution on the other side

is exempt from tax on that other side in respect of the remuneration derived from the above activities for a period of three years. This is subject to the proviso that the relevant remuneration has been subject to tax on the side where the person concerned is employed.

### Resident of both sides for non-individual entity

Under Article 4 of the DTA, if a person other than an individual is a resident of both sides, then it shall be deemed to be a resident only of the side in which its place of effective management is situated.

The Fifth Protocol replaced the above tie-breaker rule with a mutual agreement approach. Where a person other than an individual is a resident of both sides, the competent authorities of China and Hong Kong shall, for the purpose of the DTA, endeavour to reach mutual agreement on the place of residence of which such person shall be deemed to be resident. The following factors shall be considered on a case-by-case basis when determining the place of residence:

- the place of effective management of the entity;
- the place where the entity is incorporated or otherwise constituted; and
- any other relevant factors.

Such entity shall not be entitled to any tax relief or exemption under the DTA without the mutual agreement of the competent authorities except the degree and manner of the tax relief and exemption are otherwise agreed by the competent authorities.

### Anti-avoidance provisions on permanent establishment ("PE") for commissionnaire arrangement

The Fifth Protocol extends the definition of PE of resident in Article 5 the DTA to adhere to the transfer pricing legislation passed in Hong Kong in 2018 as well as the relevant Departmental Interpretation and Practice Notes ("DIPNs") recently published by the Inland Revenue Department on the same day which the Fifth Protocol was signed. Such measures were incorporated to prevent treaty abuse, which form part of the BEPS package promulgated by the OECD to ensure that the DTA follows the latest international standard. In particular, the Fifth Protocol incorporates changes which adopt the definition of dependent agent permanent establishment in OECD BEPS Action 7.

Under the Fifth Protocol, despites the absence of a fixed place of business, an enterprise that is a non-resident person is taken to have a PE in Hong Kong in respect of any activities that a resident person undertakes for the enterprise if:

a) the resident person is acting in Hong Kong on behalf of the enterprise and in doing so –

    i. habitually concludes contracts; or

    ii. habitually plays the principle role leading to the conclusion of contracts that are routinely concluded without material modification of the enterprise; and

b) the contracts are –

    i. in the names 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.

The above does not apply if the resident person:-

a) carries on business in Hong Kong as an independent agent; and

b) acts for the enterprise in the ordinary course of that business.

However, the resident person is not an independent agent if the resident person acts exclusively, or almost exclusively, on behalf of one or more enterprises that are closely related to the enterprise.

### Gain on disposal of shares or comparable interest in an entity with substantial immoveable property

Under Article 13 of the DTA, gains derived from the alienation of shares in a company in which the assets are comprised not less than 50% immovable property situated in one side at any time within the 3 years before the alienation of shares may be taxed in that side.  Therefore, a Hong Kong resident who disposes of shares in a company with substantial immovable property in mainland China is subject to tax in mainland China and no exemption from tax in mainland China is available under the DTA.

The Fifth Protocol extends the taxing right on top of shares to include comparable interest in other entities such as partnership and trusts.  Further, the Fifth Protocol has updated the quantum of “not less than 50%” to “more than 50%”.

## KPMG observations

The Fifth Protocol will come into force after the completion of ratification procedures and notification by both sides. The tax relief for teachers and researchers would be a welcomed measure to drive the development of scientific research and innovation in the Guangdong-Hong Kong-Macau Greater Bay Area.

Given the update of threshold for PE in the DTA, taxpayers with Hong Kong-China structures should consider the impact of the Fifth Protocol on their commissionaire arrangements and evaluate the need for restructuring. The BEPS dependent agent PE rule is explained in the updated OECD Model Tax Commentary as focusing on whether the local representative of a foreign enterprise “convinced” local market customers to enter into contracts with the enterprise. While the Chinese State Taxation Administration (“STA”) is yet to provide guidance on the application of the new PE rule, this is clearly a lower threshold than the existing rule, which focuses on whether the foreign enterprise ‘authorised’ the local representative to enter into contracts binding on it. The new definition of “independent agent” also requires refreshed consideration on whether local China marketing support subsidiaries may be excluded from scope.

While China did not opt for the BEPS PE updates at the time of signing the multilateral instrument in 2017, it has subsequently included the BEPS dependent agent PE rule in its new and updated treaties with Argentina, India, New Zealand and Spain – giving the growing number of treaties for which the provision is relevant, STA guidance is expected in due course. It should be noted that China typically applies deemed profit approaches for the calculation of PE profits, which in the case of selling agents may be calculated as a percentage of sales. As such it cannot be assumed that, if a local marketing support subsidiary receives an arm’s length consideration, that there will be no further profit to tax. The changes are thus of particular interest to foreign multinationals using Hong Kong as their sales platform for China.

Chinese enterprises operating in/through Hong Kong should also consider any additional exposures under the new PE rules. In this regard, consideration should be given to the new PE profit allocation principles set out in DIPN 60 which income or loss of a non-Hong Kong resident person attributable to the person’s PE in Hong Kong to be determined as if the PE were a distinct and separate enterprise. Please refer to our Hong Kong Tax Alert Issue 6 – July 2019 for further details.

For more information and assistance, please contact your usual tax advisor or one of our tax contacts below.

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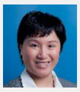

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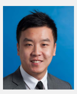

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