

Hong Kong Tax Alert

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Hong Kong's Double Tax Agreements will soon be modified by the OECD's BEPS Multilateral Instrument

Summary

With the People's Republic of China (China) depositing its instrument of approval for the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (Multilateral Instrument or MLI) with the OECD in May 2022, the Hong Kong Special Administrative Region (Hong Kong) is one step closer to implementing the MLI in Hong Kong.

When the MLI enters into effect in Hong Kong, a number of existing Double Tax Agreements (DTAs) of Hong Kong will be modified by the MLI to incorporate the tax treaty related BEPS measures recommended by the OECD under BEPS Action 6 (preventing tax treaty abuse) and Action 14 (making dispute resolution more effective). Both Actions 6 and 14 are a minimum standard under the BEPS 1.0 Action Plan.

In this news alert, we summarise the changes that will be brought by the MLI to Hong Kong's existing DTAs, the potential impact on Hong Kong businesses and how they should prepare for the changes.

China deposited its instrument of approval for the MLI (which also covers the DTAs of Hong Kong) with the OECD on 25 May 2022¹. In addition, a full list of Hong Kong's final reservations and notifications in respect of the MLI² was deposited with the OECD by China on behalf of Hong Kong on the same date.

The MLI will enter into force on 1 September 2022 in both China and Hong Kong. However, the MLI will only become effective in Hong Kong after completion of the domestic ratification procedures to incorporate the MLI as subsidiary legislation in Hong Kong. The MLI is expected to take effect in Hong Kong in 2023 at the earliest.

How does the MLI work to modify existing bilateral tax treaties?

The MLI contains articles that modify the OECD Model Tax Convention to implement the following tax treaty related measures recommended by the OECD under BEPS 1.0 Action Plan³:

- Action 2 - Neutralising the effects of hybrid mismatch arrangements;
- Action 6 - Preventing tax treaty abuse⁴;
- Action 7 - Preventing the artificial avoidance of permanent establishment status; and
- Action 14 - Making dispute resolution mechanisms (i.e. mutual agreement procedure (MAP) and arbitration) more effective (Action 14)⁴

¹ Please refer to this link for more details: [China deposits an instrument for the approval of the Multilateral BEPS Convention - OECD](https://www.oecd.org/tax/beps/beps-actions/)

² Please refer to this link for the full list: [beps-ml-position-hong-kong-instrument-deposit.pdf \(oecd.org\)](https://www.oecd.org/tax/beps/beps-actions/)

³ Please refer to this link for more details of the 15 actions under the BEPS 1.0 Action Plan: <https://www.oecd.org/tax/beps/beps-actions/>

⁴ This is a minimum standard under BEPS 1.0 Action Plan of which the members of the OECD's Inclusive Framework on BEPS (including Hong Kong) have committed to adopt.

A Party or Contracting Jurisdiction of the MLI can:

- choose which of its existing bilateral tax treaties are to be covered and modified by the MLI (i.e. the Covered Tax Agreements);
- make reservations for (i) not applying certain articles of the MLI (e.g. articles for implementing measures related to Actions 2 and 7 which are not minimum standards) or (ii) not applying certain articles of the MLI to certain Covered Tax Agreements (i.e. because the agreements already contain provisions that are the same as or similar to those in the MLI); and
- make notifications to indicate its choices of optional provisions (where available) for some of the articles in the MLI (e.g. there are different options of the provisions governing the effective date of the MLI provisions from which the Contracting Jurisdictions can choose).

The above choices made by a Party to the MLI are reflected in that Party's "MLI position" deposited with the OECD.

In most cases, a particular provision in an existing bilateral tax treaty will be modified/replaced or a new provision will be added to that treaty **only if both Contracting Parties of the treaty adopt the same position in respect of a given MLI provision**. This means that in determining how the MLI modifies a specific bilateral tax treaty, one has to go through a process of comparing and matching the MLI positions taken by the two Contracting Parties to the treaty⁵.

Summary of the potential changes to Hong Kong's DTAs

DTAs covered by the MLI

39 out of 45 existing DTAs of Hong Kong are covered by the MLI. The DTAs that are not covered are those signed with China, Estonia, Finland, Georgia, the Macau SAR and Serbia. These DTAs are either (i) not signed with a separate sovereign state (i.e. the ones with China and the Macau SAR) or (ii) signed recently (in 2018 or after) and have already contained all the MLI provisions that Hong Kong has chosen to adopt (see details below).

The MLI provisions adopted by Hong Kong

Hong Kong will only adopt those MLI provisions that implement the minimum standards under the BEPS 1.0 Action Plan that are related to tax treaties, namely **preventing tax treaty abuse (Action 6) and making dispute resolution more effective (Action 14)**. Hong Kong has opted out of all the other MLI provisions that deal with other tax treaty related measures to prevent BEPS.

Action 6 – Preventing tax treaty abuse

Hong Kong has adopted the following MLI provisions relating to Action 6:

1. to modify the **preamble text** of Hong Kong's DTAs to: (i) specify that the DTAs are not intended to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance and (ii) refer to the desire of the Contracting Parties to further develop the economic relationship and enhance the co-operation in tax matters; and
2. to adopt the **principal purpose test (PPT)** – i.e. to deny a treaty benefit if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless granting that benefit in those circumstances would be in accordance with the object and purpose of the tax treaty.

Among the 39 covered Hong Kong DTAs, 2 (the ones with Belarus and Pakistan) already contain the exact PPT wording in (2) above and will not be modified by the MLI, 18 already contain a PPT but the wording of which is not the same as in (2) above, and the remaining 19 do not contain a PPT currently. Whether the 37 DTAs mentioned above will be modified by the MLI to incorporate the exact PPT wording in (2) above will depend on the choice made by the relevant treaty partners.

The table below includes a few examples to illustrate how Hong Kong's existing DTA will be amended differently depending on different MLI positions taken by its treaty partners under Action 6⁶:

DTA	Changes to the preamble text	Changes related to the PPT
HK/Japan ⁷	Notification matched – preamble text will be amended to include 1(i) and 1(ii) above	Notification matched – The original "main purpose test" wording in Limitation of Relief article (Article 26) will be replaced by the PPT wording in (2) above

⁵ The OECD has developed a [MLI Matching Database](#) that makes projections on how the MLI modifies a specific tax treaty by matching information from Signatories' MLI positions.

⁶ The changes to the Hong Kong DTAs shown in the table are based on the information produced by the OECD's MLI Matching Database and the English version of the synthesized text of the relevant Hong Kong DTAs published by the treaty partners (if any).

⁷ The synthesised text of the Hong Kong/Japan DTA as modified by the MLI published by the Japanese government can be accessed via this link: [SynthesizedTextforJapan_HongKong_EN.pdf \(mof.go.jp\)](#)

DTA	Changes to the preamble text	Changes related to the PPT
HK/France	Notification mismatch – preamble text will only include 1(ii) but not 1(i) above	Notification matched - The original “one of the main purposes test” wording in the Dividends, Interest, Royalties and Capital Gains articles will be replaced by the PPT wording in (2) above
HK/Ireland HK/Luxembourg HK/Netherlands HK/Vietnam ⁸	Notification matched – preamble text will be amended to include 1(i) and 1(ii) above	Both parties apply the PPT wording in (2) above and the existing DTA does not contain any PPT provisions – the PPT wording in (2) above will apply and supersede the provisions of the DTA to the extent of incompatibility
HK/Switzerland	No change - the DTA is not a Covered Tax Agreement as Switzerland has not included it as a Covered Tax Agreement in its MLI position deposited with the OECD	

Action 14 - Making dispute resolution more effective

Hong Kong has adopted the following MLI provisions relating to the **MAP**:

1. to allow a person to present a MAP case to the competent authority of **either** Contracting Party (rather than just the Contracting Party of which that person is a resident);
2. to allow a person to present a MAP case within **three years** from the first notification of the action resulting in taxation not in accordance with the provisions of the tax treaty;
3. to implement any agreement reached under MAP **notwithstanding any time limits in the domestic law** of the Contracting Parties; and
4. to provide for the competent authorities of the Contracting Parties to **consult together** for the elimination of double taxation in cases not provided for in the tax treaty.

The MAP articles of most of the existing Hong Kong DTAs have already contained provisions on (2), (3) and (4) above whereas the majority of Hong Kong’s DTAs do not meet the requirement in (1) above.

The MLI provisions on mandatory binding arbitration are optional and Hong Kong has chosen not to adopt them.

The table below includes a few examples to illustrate how the MAP article of Hong Kong’s existing DTA will be amended differently depending on different MLI positions taken by its treaty partners and/or the existing provisions in the MAP article⁶:

DTA	Changes to the MAP article
HK/Japan HK/UK	<ul style="list-style-type: none"> • Will be amended to incorporate (1) above as the DTAs already contain provisions on (2) to (4) above
HK/Italy ⁹	<ul style="list-style-type: none"> • Will be amended to incorporate (2) and (3) above since Italy has reserved the right not to apply (1) and the DTA already contains provisions on (4) above. The current time limit for presenting a MAP case specified in the DTA is within 2 years.
HK/Belgium	<ul style="list-style-type: none"> • Will be amended to incorporate (1) and (4) above as the DTA already contains provisions on (2) & (3) above
HK/Canada HK/Indonesia	<ul style="list-style-type: none"> • No change as Canada and Indonesia have reserved the right not to apply (1) above and the DTA already contains provisions on (2) to (4) above

⁸ Vietnam has not yet deposited the MLI ratification document with the OECD as of 28 July 2022.

⁹ Italy has not yet deposited the MLI ratification document with the OECD as of 28 July 2022.

Entry into effect of the MLI provisions

The effective dates of the changes to the Hong Kong DTAs brought by the MLI will vary from treaty to treaty as it depends on a number of factors such as: whether the relevant treaty partners have completed the ratification procedures of the MLI and which MLI provisions on “entry into effect” they have chosen to adopt.

Hong Kong has chosen the following provisions on entry into effect of the MLI provisions:

- with respect to withholding taxes (WHT) – the changes apply to events occurring on or after the first day of the next taxable period that begins on or after 30 days after the date of receipt by the OECD of the notification by China that Hong Kong has completed its internal procedures for the entry into effect of the provisions of the MLI; and
- with respect to all other taxes – the changes apply to taxes levied with respect to taxable periods beginning on or after the expiration of a period of six calendar months from 30 days after the date of receipt by the OECD of the notification by China that Hong Kong has completed its internal procedures for the entry into effect of the provisions of the MLI.

Assuming Hong Kong can complete its domestic ratification procedures of the MLI within the fourth quarter of 2022 and China will deposit the notification with the OECD by the end of January 2023, the table below shows the effective dates of the MLI changes with respect to the HK/Japan and HK/Italy as examples:

DTA	Effective dates of the MLI changes
HK/Japan	<p>In Japan:</p> <ul style="list-style-type: none"> • For WHT – on or after 1 January 2024 • For other taxes – with respect to taxable periods beginning on or after 1 January 2024 (assuming the taxable period follows the calendar year) <p>In Hong Kong:</p> <ul style="list-style-type: none"> • For WHT – on or after 1 April 2023 • For other taxes – with respect to year of assessment beginning on or after 1 April 2024
HK/Italy ⁸	The dates of entry into effect in Italy and Hong Kong respectively will depend on when the domestic ratification procedures in Italy are completed.

KPMG observations

The potential impact of the MLI implementation on Hong Kong resident business groups will largely depend on the treaty jurisdictions of which the groups are investing in or doing business with as the changes brought by the MLI will vary from treaty to treaty.

Among the various changes brought by the MLI to Hong Kong’s DTAs, the most significant one will be the addition of the PPT to those Hong Kong DTAs that currently do not contain such test or any other limitation of benefits provisions¹⁰. Such most affected DTAs include the one signed with Belgium, Ireland, Luxembourg, Malaysia, Thailand, the United Arab Emirates and Vietnam, etc. The newly added PPT will be applicable to all articles in the DTAs, including the Dividends, Interest, Royalties, Capital gains and Other income articles.

Hong Kong resident business groups that are receiving dividends, interest or royalties from the most affected DTA jurisdictions or planning to divest their investments in these jurisdictions should review their existing holding/investment structures, assess the risks of treaty benefit denial resulting from the application of the PPT, and consider whether any changes to the current structures would be desirable.

On the other hand, foreign resident entities wishing to obtain a treaty benefit (e.g. a reduced WHT rate on royalties) from Hong Kong under a Hong Kong DTA should also evaluate whether the current structure or arrangement can withstand any potential challenges from the Hong Kong Inland Revenue Department under the PPT.

¹⁰ Other than an article specifying that each Contracting Party can apply its domestic laws and measures concerning tax avoidance.

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