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CHINA TAX ALERT

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New China – Hong Kong tax arrangement protocol to boost Hong Kong leasing and asset management industries

Regulations discussed in this issue:

- *Fourth Protocol to the Arrangement between the Mainland and Hong Kong Special Administrative Region (Hong Kong SAR) for the Avoidance of Double Taxation and Prevention of Tax Avoidance*, signed on 1 April 2015
- *Arrangement between the Mainland and Hong Kong SAR for the Avoidance of Double Taxation and Prevention of Tax Avoidance*, effective from 8 December 2008
- *Notice on relevant Tax Treatment for the Pilot Programme Shanghai-Hong Kong Stock Connect*, Caishui [2014] No. 81 issued by the MOF, SAT and CSRC on 14 November 2014
- *Notice on the Temporary Corporate Income Tax Exemption for Capital Gains derived from the transfer of PRC Shares and Equity Interests*, Caishui [2014] No. 79 issued by the MOF, SAT and CSRC on 14 November 2014

Background

On 1 April 2015 the governments of the People's Republic of China (PRC) and the Hong Kong SAR signed the Fourth Protocol (the Protocol) to the China - Hong Kong Double Tax Arrangement (DTA) of 2008.

The Protocol provides 'best in class' tax treaty treatments for Hong Kong enterprises undertaking aircraft and ship leasing from the Mainland and those conducting cross border public market securities investment activities. These tax treatments are superior to those conferred by China to other jurisdictions to date and would boost Hong Kong's development as a capital equipment leasing hub and asset management centre.

The Protocol also introduces new DTA anti-avoidance provisions and an updated exchange of information article which is in line with the PRC's more rigorous international tax enforcement initiative in the context of the G20/OECD Base Erosion and Profit Shifting (BEPS) Action Plan.

Protocol updates

Royalty withholding tax

Lease rentals derived from aircraft and ship leasing businesses (excluding the interest portion under a finance lease arrangement), covered under the DTA Royalties article, are now subject to a reduced rate of withholding tax (WHT) of 5%, down from 7%. This is the lowest royalty WHT rate among all of China's DTAs and lower than the 6% rate applicable to the two principal jurisdictions currently used for aircraft leasing into China, namely Ireland and Singapore. This WHT change is accompanied by a Value Added Tax (VAT) exemption - to account for VAT reform - for income derived by a Hong Kong company from the provision of air, land and sea transport services to Chinese customers.

Capital gains

The Protocol also provides clarifications that capital gains derived from shares trading where both the purchase and sale of shares in listed companies on a recognised exchange platform by either Hong Kong or China enterprises, will be exempt from tax in the jurisdiction where listed shares are transacted. This provision is taken to apply even where the listed company is land-rich or where the shareholding is greater than 25% of the disposed company's total equity. These are cases where, under most of China's DTAs, China would generally retain a taxing right.

Clarifications are also provided to permit an investment fund, established in Hong Kong, to be considered as tax resident in Hong Kong and therefore to be eligible for this listed shares relief in its own right. A Hong Kong resident fund is defined as:

- An investment fund established under the laws of Hong Kong, which is registered with and supervised by the Securities and Futures Commission of Hong Kong
- The manager of the fund should be a Hong Kong incorporated company
- More than 85% of the funding should be raised in the Hong Kong market. This includes funding raised through the Hong Kong Stock Exchange, capital raised by sale/placement via financial institutions with substantial operations in Hong Kong or directly to investors, and other arrangements mutually agreed by the tax authorities in Hong Kong and China

Treaty abuse and exchange of information

As has been the trend for new and updated DTAs of China over the past three years, the Protocol inserts anti-avoidance rules in the dividend, interest, royalties and capital gains articles providing that DTA benefits will not be available if the main purpose for entering into an arrangement was to secure a more favorable tax position.

The Protocol also extends the definition of PRC taxes subject to the exchange of information article under the DTA to include VAT, Consumption Tax, Business Tax, Land Appreciation Tax and Real Estate Tax.

KPMG observations

The Protocol is highly advantageous to Hong Kong and the revised DTA offers significant comparable benefits to Hong Kong enterprises conducting cross border investments and business activities with the Mainland. The reductions to royalties WHT and the exemption from VAT on shipping, land and air transport would be a propelling factor to enhancing Hong Kong's position as a leasing hub in the region.

The Protocol's exemption for gains realized on listed securities, traded on Chinese public markets by Hong Kong residents, reinforces the exemptions for dealings in China A-shares provided since November 2014 under Chinese domestic law; see *China Tax Alert Issue 29 (November 2014)*. Those exemptions, for QFIIs, RQFIIs and Shanghai - Hong Kong Connect investors, are 'temporary' exemptions (with no stated period of effect) though, and the tax treaty based exemption provided for under the Protocol may be considered to be more 'secure'. The Protocol hence should be conducive to attracting more foreign investors to establish trading platforms in Hong Kong to transact in A-shares. The confirmation that Hong Kong based investment funds will be granted relief as Hong Kong tax residents in their own right supports this position further.

The Protocol anti-avoidance DTA updates follow China's general DTA update policy and are aligned with China's recent focus on BEPS. The expansion of the scope of the information exchange provision is also aligned with recent enhanced Chinese efforts at tax information collection and exchange, and reflects the large proportion of capital flows, in and out of China, which go through Hong Kong, and the degree to which Chinese enterprises conduct outbound investments via Hong Kong.

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