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Hong Kong Tax Alert

Signing of the Second Protocol to the Hong Kong-Mainland of China Comprehensive Double Taxation Arrangement

Overview

On 30 January 2008, Hong Kong and Mainland China signed a second protocol (the "Second Protocol") to the Arrangement between the Mainland of China and Hong Kong for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income ("the Comprehensive Arrangement").

The Second Protocol amends the terms of the Comprehensive Arrangement and a previous protocol thereto (the "First Protocol"). The main objective of the Second Protocol is to resolve certain differences with regard to the interpretation of the Comprehensive Agreement[1] by the Hong Kong Inland Revenue Department ("IRD") and the Mainland State Administration of Taxation ("SAT").

Differences Resolved by the Second Protocol

The furnishing of services by way of a permanent establishment under the Comprehensive Arrangement

In determining whether the furnishing of services by an enterprise of One Side in the Other Side would result in that enterprise as having established a permanent establishment ("PE") in the Other Side under the Comprehensive Arrangement, the IRD and the SAT had differences on the interpretation of what constituted a period or periods aggregating "more than 6 months within any 12-month period".

The Second Protocol resolves these differences by adopting the term "183 days" in place of the previous controversial term "6 months" in the relevant provision of the Comprehensive Arrangement.

Taxability of capital gains under the Comprehensive Arrangement

Under Article 13 of the Comprehensive Arrangement, gains derived by a Hong Kong resident investor from a disposal of a less than 25% interest in a Mainland company, the assets of which are not comprised mainly, directly or indirectly, of immovable property on the Mainland, would be exempt from the Mainland capital gains tax.

However, the IRD and SAT had different views on (i) the time frame with respect to ascertaining whether the assets of a company would be considered as comprising mainly of immovable property; and (ii) the period over which the 25% holding threshold was to be applied.

The Second Protocol resolves these issues by specifying a 3-year and a 12-month look-back period respectively.

1 For further details as regards the provisions of the Comprehensive Arrangement and the differences of the IRD and SAT on the interpretation of certain provisions of the Comprehensive Arrangement, please refer to Ernst & Young's August 2006 and May 2007 Tax Alerts.

Effective date of the Second Protocol

It should be noted that the Second Protocol will only be effective upon the latter date of each party notifying the other of the completion of the ratification procedures necessary on each Side, the same being expected to take a couple of months to complete.

Opportunities under the Second Protocol

The above favorable treatments under the Second Protocol with regard to the furnishing of services by way of a PE and the specifying of the particular time periods to be applied under the Capital Gains Article may be particular to the Comprehensive Arrangement and generally not available under China's tax treaties with other countries. Clients are advised to review their current or proposed structures for China operations and investments in light of the Second Protocol. Please consult your tax executives should you have any questions in this regard.

Detailed Discussion of the Second Protocol

The furnishing of services by way of a permanent establishment under the Comprehensive Arrangement

Under Article 5 of the Comprehensive Arrangement, where services, including consultancy services, have been furnished by an enterprise of One Side directly or through employees or other personnel in the Other Side for a period or periods aggregating "more than 6 months within any 12-month period", such an enterprise will be considered as having established a PE in the Other Side.

Profits attributable to such a PE will then be subject to tax in the Other Side in accordance with the provisions of Article 7 (Business Profits) of the Comprehensive Arrangement.

However, prior to the guidance provided by way of the Second Protocol as regards Article 5 of the Comprehensive Arrangement, the IRD and SAT held different views on how the "6 month" period should be counted.

The SAT was of the view that for a project lasting not longer than 12 months, a Hong Kong enterprise's presence on the Mainland was taken as including all the months starting from the day when the enterprise first had employees or other personnel rendering services on the Mainland in relation to the project to the last day such services were rendered. From this duration, the SAT nonetheless agreed that a month could be deducted whenever such services were continuously absent on the Mainland for 30 days during any period of the project.

For a project lasting longer than 12 months, the relevant period for applying the aforesaid test was any 12-month period rolling either forward or backward from the date of any arrival or departure of an employee or other personnel of an enterprise of One Side rendering services in relation to the project in the Other Side.

Under such an interpretation, in an extreme case, the provision of services by a Hong Kong enterprise for a single day within a calendar month on the Mainland would be counted as one month's presence on the Mainland for the purposes of the service PE provision of the Comprehensive Arrangement.

Conversely, the IRD was of the view that a month comprised 30 days and therefore the relevant days of presence should be counted separately and then added together to ascertain if the aggregate number of days exceeded 180 (i.e. 30 days x 6) within any 12-month period.

To avoid the problems arising from these differing interpretations of what constituted a month, the two parties have now agreed by way of the Second Protocol to amend the terms of the relevant provision from "more than 6 months within any 12-month period" to "more than 183 days within any 12-month period"[2].

Under the amended provision, a resident enterprise of One Side will only be considered as having established a PE in the Other Side – if that enterprise renders services for a period or periods aggregating more than 183 days in any 12-month period in the Other Side.

2 The "183 days within any 12-month period" service PE provision now applicable under the Comprehensive Arrangement is adopted by China in very few of its tax treaties. The relevant provisions in many other treaties still use the terms "6 months within any 12-month period".

Capital gains tax provision of the Comprehensive Arrangement

Under Article 13 of the Comprehensive Arrangement, gains derived by a Hong Kong resident investor from a disposal of an interest of less than 25% in the shares of a Mainland company, the assets of which are not comprised mainly, directly or indirectly, of immovable property on the Mainland, would be exempt from Mainland capital gains tax.

Ascertaining whether the assets of a company are comprised mainly, directly or indirectly, of immovable property

Pursuant to paragraph 2 of the First Protocol to the Comprehensive Arrangement, where the value of the immovable property held by a company was 50% or more of the value of the total assets of the company, directly or indirectly, the assets of that company would be deemed to comprise mainly of immovable property (i.e., said company would be a "property-holding company").

In this regard, the IRD and SAT held different views as to (i) the time frame under which the value of the immovable property and total assets of the company should be taken into account in determining the 50% asset threshold; and (ii) whether the historical book value or market value of an asset was to be used in the calculation.

The IRD held the view that the only relevant point of time for determining the 50% asset threshold was the date of disposal of the shares in question, using market value. Conversely, the SAT held the view that the relevant time frame for determining the 50% asset threshold should be any one point of time before the disposal during which the investor had held the shares, using historical book value.

To resolve the above discrepancy, the two parties have now agreed to amend the First Protocol by way of the Second Protocol to the effect that the relevant time frame for ascertaining the 50% asset threshold is within 3 years before the date of disposal of the shares in question.

Separately, by way of an exchange of letters the two parties have also agreed that historical cost based on the year-end book value within 3 years prior to a disposal will be used in calculating the 50% asset threshold.

Ascertaining the 25% shareholding threshold

The following differences in interpretation arose between the IRD and SAT. The IRD considered that the 25% threshold referred to the percentage of each disposal of shares, regardless of the total shareholding that an investor had in the company concerned. Under such an interpretation, capital gains derived by a Hong Kong resident investor would be exempt on the Mainland when the shares disposed of were less than 25% of the capital of the Mainland company (where the company was not a property-holding company).

However, the SAT took the view that the 25% threshold referred to the shareholding that a Hong Kong resident investor held at any point of time before the disposal. Under such an interpretation, if a Hong Kong resident investor held a 25% or more interest in the capital of a Mainland company at any time, any subsequent disposal of part of or the whole shareholding, regardless of the percentage involved, would not be exempt from the Mainland capital gains tax.

To resolve the above discrepancy, the two parties have now agreed, by way of the Second Protocol, that the 25% threshold is to be ascertained by reference to an investor's direct or indirect shareholding in the company concerned at any one point of time during the 12-month period immediately before a share disposal.

That means, on the effective date of the Second Protocol and thereafter, gains derived by a Hong Kong resident from a disposal of a less than 25% interest in a non property-holding company of the Mainland will be exempt from the Mainland capital gains tax - provided that the Hong Kong resident has not owned, directly or indirectly, 25% or more of the shareholding in that Mainland company during the 12-month period preceding the disposal.

As regards the taxation of capital gains, this amendment will put Hong Kong's Comprehensive Arrangement with the Mainland on par with the treaties China has signed with Mauritius and Singapore, two other commonly considered jurisdictions for holding Chinese investments.

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Taking the above clarifications as to the instances when a capital gain will be assessed to tax in the Mainland, together with the generally more favorable withholding rates on dividends, interest and royalties available under the Comprehensive Arrangement; Hong Kong's favorable tax regime as regards holding companies generally; and Hong Kong's unique cultural and geographical links with the Mainland, it is expected that the implementation of the Second Protocol will further enhance Hong Kong attractiveness as a holding jurisdiction for investors on the Mainland.

Other Changes Implemented by the Second Protocol

The Second Protocol also amends certain terms including the reference to "Mainland taxes" and the definition of "Mainland resident" used in the Comprehensive Arrangement. These amendments however do not impact on the provisions of the Comprehensive Arrangement and are merely intended to reconcile the Comprehensive Arrangement with the recent promulgation of the New Corporate Income Tax Law on the Mainland.

Effective Date of the Second Protocol

The Second Protocol will only be effective upon the latter date of each party notifying the other of the completion of the necessary ratification procedures on each Side, the same being expected to take a couple of months to complete.

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